SPICER AND PEGLER'S

BOOK-KEEPING AND ACCOUNTS

Fifth Edition

by

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CHAPTER I

DOUBLE ENTRY BOOK-KEEPING

§ 1. Introduction

Business transactions comprise the exchange of value, either in the form of money, or of goods or services which are measured and expressed in terms of money. Book-keeping is the systematic recording of such transactions in a manner which enables the financial relationship of a business with other persons to be clearly disclosed, and the cumulative effect of the transactions on the financial position of the business itself to be ascertained.

It is by no means easy to draw a clear line of distinction between book-keeping and accountancy. Broadly speaking, however, the function of the book-keeper is to keep the books and make the accounting records, whilst that of the accountant is to decide how such records shall be kept and to appraise the significance of the information disclosed thereby.

The accountant is responsible for directing and co-ordinating the work of the book-keeping staff, and for designing and maintaining accounting systems adequate to the needs of the particular business. It is part of his duty to prepare periodical accounts of profit and loss and financial statements in a form which will be of assistance to the management, not only in appraising past results, but in formulating future policy. By careful and scientific analysis of accounting records he can bring to light significant facts which will enable errors in management and policy to be rectified and reforms and economies to be introduced. He must be competent to devise and consolidate the accounting records of branches and subsidiaries, install and direct costing systems and generally to advise the management and give effect to their policy on all matters affecting the business in its financial and accounting aspects.

The principles of double entry book-keeping are described and illustrated in full detail in Spicer and Pegler's *Practical Book-Keeping and Commercial Knowledge* and are only dealt with in brief outline in this work, which is devoted mainly to the higher functions of accountancy.

§ 2. The Theory of Double Entry

Double Entry Book-keeping takes cognisance of the fact that every transaction which is capable of being recorded in terms of money involves the receiving of value by one or more persons and the giving of equivalent value by another or others. The system accordingly requires entries to be made in the books of a business to give effect to both aspects of the transactions.

The principal book of account is the LEDGER, and although, normally, a number of subsidiary books are also necessary, it is the Ledger in which all transactions are ultimately recorded in double entry form. The Ledger is divided into 'accounts', each

being devoted solely to transactions with a particular person, or of a particular kind. Accounts dealing with persons are called 'PERSONAL ACCOUNTS' and those in which transactions are recorded from the viewpoint of the business, 'IMPERSONAL ACCOUNTS'. The latter class is further subdivided into 'REAL ACCOUNTS' which are concerned with things (*e.g.*, plant and machinery, buildings, etc.) and 'NOMINAL ACCOUNTS' in which the various kinds of expense, income, profit and loss are recorded.

The simplest form of ledger account is divided vertically into two sides, that on the left being called the 'debit' and that on the right the 'credit' side of the account. Accordingly, an entry on the left hand side of a ledger account is called a debit, and one on the right hand side a credit to that account.

The fundamental rule of double entry may now be concisely stated, as follows:

The account which RECEIVES value is DEBITED;

The account which GIVES value is CREDITED.

Thus, if XY & Co. sells goods of the value of £100 on credit to AB & Co., in the books of XY & Co. the personal account of AB & Co. is debited and the impersonal account for Sales is credited with £100, AB & Co. having received the value, and Sales Account being the account in which the 'giving' of value in the form of sales is recorded. When, later, AB & Co. pay the £100, their account is credited, because they 'give' the value, and Cash Account is debited, because this account 'receives' it.

It must be observed that the value received by, and consequently debited to, an account is not in all cases something tangible, such as goods or cash. The payment of wages, for example, is made as consideration for a *service* received by the business, *viz.*, the labour of employees, and must be debited to Wages Account, which represents that type of service. The value received may even be of a negative character, and constitute a loss, such as a bad debt which, when sustained, must be debited to the account which 'receives' the loss, *viz.*, Bad Debts Account, and credited to the account of the defaulting debtor, which yields it.

Again, the account which gives the value may be an impersonal one, representing the *source* of a benefit, such as income from investments. Here the amount received is debited to Cash Account and credited to Income from Investments Account, the account of the source from which the income is derived.

It will be seen from an examination of these illustrations that the rule of double entry stated above, may be amplified as follows:

(1) Receipts are debited; payments credited.

(2) Assets are debited; liabilities credited.

(3) Losses are debited; profits credited.

(4) Expenses are debited; income credited.

From the above considerations, the following advantages of the double entry system of book-keeping may be deduced:

(1) It provides a complete record of every transaction, from both its personal and impersonal aspects.

(2) It provides an arithmetical check on the records, since the total of the debit entries must equal the total of the credit entries, and as a consequence, the total of the debit *balances* must equal the total of the credit *balances*.

(3) From the personal accounts the amounts owing to and by each person with whom the business deals can at any given time be ascertained.

(4) The balances of the nominal accounts can be collected together in a Profit and Loss Account, which discloses the result of the operations, *i.e.*, the profit or loss for any given period.

(5) By means of a Balance Sheet, in which the balances of accounts representing capital, assets and liabilities are set out, the financial position of the business at any given moment, can be ascertained.

(6) In association with a reliable system of internal organisation, it reduces the risk, and facilitates the detection of, errors and fraud.

§ 3. The Various Classes of Assets and Liabilities

Assets may be classified as follows:

(*a*) FIXED ASSETS are those which are acquired for continuous use in the business, and not for conversion into cash. The life of such assets usually extends over a number of years, and the operations of many accounting periods derive benefit from them. The cost of fixed assets, therefore, represents capital expenditure, which, instead of being charged wholly against the revenue of the period in which it is incurred, is spread over the effective lifetime of the assets, by charging a proportion thereof against the revenue of each of the years in which they are used. Examples of fixed assets are buildings, plant and machinery, fixtures and fittings, goodwill, etc.

(*b*) WASTING ASSETS are assets which are fixed in nature, but are gradually consumed or exhausted in the process of earning profits, *e.g.*, a mine, a cemetery.

(*c*) CURRENT (OR FLOATING) ASSETS. These consist of goods, which are acquired for the purpose of sale, and assets in the various stages of conversion into cash, such as book debts, bills receivable, and cash itself. Such assets are also referred to as 'circulating assets', because they are constantly changing in form by being 'turned over' in the process of trading. Thus, cash may be applied in purchasing goods, goods may be sold and replaced by book debts, book debts are realised into cash, and so on. It is by the turnover or circulation of current assets that profits or losses are made.

Cash, and assets that are capable of immediate realisation, *e.g.*, bills receivable, are also termed 'liquid assets'.

(*d*) FICTITIOUS (OR NOMINAL) ASSETS are debit balances resulting from expenditure of an exceptional nature, which is not represented by present value, but has not been written off. Examples are preliminary expenses (in the case of a limited company), and deferred revenue expenditure, such as special advertising, the benefit

of which will extend to future periods and which it would be inequitable to charge against the revenue of any one period. Such assets have no intrinsic value, and it is therefore desirable to write them off as soon as possible.

Assets may also be classified as 'tangible' and 'intangible', the former comprising those which have material existence, such as stock, cash, plant, etc., and the latter those which have no tangible form, but represent the value of a right, *e.g.*, goodwill, patents, book debts, etc. The use of these expressions is not recommended, as there is a tendency to depart from the literal interpretation of the terms. Intangible assets must not be regarded as necessarily fictitious; they may, in fact, be of considerable value, as in the case of goodwill and patent rights, whereas a fictitious asset is valueless.

Liabilities are amounts owing by a business. They are not capable of as varied a classification as assets, but care must be taken, in a Balance Sheet, to indicate clearly their nature. Those of a short term character, which have to be met day by day out of the current assets of the business, are classified as 'current liabilities' and the ratio of these to the current assets is important, as indicating the extent and adequacy of the working capital of the business. Cash liabilities, such as bank overdrafts and temporary loans should be clearly designated, whilst those of a more permanent character may be classified as 'fixed' or 'long term' liabilities.

§ 4. Capital and Revenue Expenditure

The distinction between capital and revenue expenditure is broadly analogous to that between fixed and current assets. Capital expenditure is all expenditure incurred in acquiring fixed assets and in placing the business in a position in which it is able to commence or continue operations. Revenue expenditure is incurred in the purchase of goods for resale, in selling those goods, and in administering and carrying on the business.

Since capital expenditure results in some more or less permanent benefit to the business, it is written off piecemeal, the proportion unexpired at the end of each accounting period being carried forward to continue to form part of the capital worth of the business. Revenue expenditure, on the other hand, contributes only once to the earning of profit, and except to the extent that it is represented by unsold stock and payments in advance, is wholly exhausted and written off against revenue in the period in which it is incurred.

For the financial health of the business, capital expenditure should be provided for by long term capital, *i.e.*, capital contributed by the proprietors, or raised in the form of mortgages or debentures, which are not repayable at an early date. Although it may be desirable for revenue expenditure also to be provided, at least partially, by long term capital, it may be financed to some extent by bank overdrafts and credit received from creditors, so long as the current assets are maintained at a figure sufficient to meet the current liabilities as they become due, and to leave an adequate margin of working capital to meet current expenses and contingencies.

§ 5. The Books of Prime Entry

Although the principle of double entry requires a debit and a credit to be made in the ledger in respect of every transaction, it is necessary first to sort out the transactions, according to their nature, by entering them in subsidiary books, or 'books of prime entry', from which they can conveniently be transferred, or 'posted' to the ledger. Any number of books of prime entry may be employed, according to the needs of the particular business. Those which will usually be found in a trading business are cash books, day books and the journal.

Cash Book

A cash book serves the dual purpose of a book of prime entry and a ledger account. It is ruled, like a ledger account, with debit and credit sides, all cash received being debited and cash paid credited. In order to complete the double entry for cash transactions, items are posted from the debit side of the cash book to the credit side of ledger accounts, and from the credit side of the cash book to the debit side of ledger accounts. A cash book is, in fact, a ledger account for cash transactions; an entry in a cash book constitutes one part of the double entry, and it only remains to make the other part.

In a large business there may be a number of cash books, according to the number of cash accounts which it is necessary to maintain. In any event there will usually be, in addition to the general cash book, a petty cash book, in which small incidental expenses, such as postages, fares, carriage, etc. are recorded.

Day Books

A day book is a book in which all transactions of a particular kind are entered preparatory to their being posted to the ledger. Separate day books will usually be found for purchases, sales, returns outwards, returns inwards, and for any other classes of transactions which are sufficiently numerous to justify the use of a separate book. As will be seen later, the double entry in the ledger in respect of transactions first entered in a day book is usually effected by posting each item to the debit or credit of the personal account of the debtor or creditor concerned, and the periodical total of the transactions to the credit or debit of the appropriate impersonal account in the ledger. Thus, each item in the sales day book is posted to the debit of the account of the customer who receives the goods, whilst the periodical total of the sales is posted to the credit of the Sales Account, which 'gives' the value.

The Journal

Formerly, the journal was the only book of prime entry, and every transaction, of whatever kind, was recorded therein in the first instance, before being posted to the ledger. In modern book-keeping, the journal has been supplanted, to a large extent, by the day books (which are, in effect, special journals) so that the use of the journal is now restricted to miscellaneous transactions and adjustments, for which no other book of prime entry is available.

§ 6. Cash Books

(a) Form of Cash Book where receipts are banked, and all payments are made by cheque. In order to minimise the risk of misappropriation of cash, all cash received should, if possible, be paid into a bank account intact, and all payments, apart from petty disbursements, should be made by cheque drawn on that account. The cash book should contain columns on either side for *Details* and *Bank*, each sum received being entered on the debit side in the *Details* column, and the amount of each lodgment with the bank (which should agree with the amount appearing in the bank paying-in slip) extended into the *Bank* column. On the credit side, the amount of each cheque drawn on the bank account is entered in the *Bank* column, so that the *Details* column need only be used where one cheque is drawn to provide for two or more payments. As has been already explained, entries on the debit side of the cash book are posted to the credit side of the corresponding account in the ledger, and entries on the credit side of the cash book to the debit side of the ledger.

Where cash discounts are allowed and received, additional columns therefor must be provided on each side of the cash book.

CASH DISCOUNT is an allowance made by a creditor to his debtor in consideration of the amount of the debt being paid either immediately, or within a specified period, called the period of credit. The discount is deducted by the debtor from the sum due, when making the payment. When a cash discount is allowed by the business, the amount thereof is entered in the *Discounts* column on the debit side of the cash book, and posted, together with the cash to which it relates, to the credit side of the account of the payer. Similarly, discount received is entered in the *Discounts* column on the credit side of the cash book, and posted, together with the cash paid, to the debit of the account of the payee. On balancing the cash book, the *Discount* columns are cast and ruled off, the total of the *Discounts Allowed* column being posted to the *debit* side, and the total of the *Discounts Received* column to the *credit* side of the Discount Account in the ledger.

It will be observed that whereas, in respect of cash receipts and payments, the cash book serves the purpose of a ledger account, so that in order to complete the double entry it is only necessary to post each item to the *opposite* side of the ledger, the *Discount* columns merely contain memoranda of the discounts allowed and received, and entries therein must be posted *twice* to the ledger, *viz.* to the debit or credit, as the case may be, of the personal account involved, and in total to the credit or debit of the Discount Account. In explanation of the apparent paradox that the account of a person to whom discount is allowed is credited with the amount of the discount, it must be borne in mind that by paying his account earlier than was absolutely necessary, the debtor has yielded, and the business has received, a benefit, the value of which is measured in terms of discount. Accordingly, the account which receives the benefit, *viz.*, the Discount Account of the business is debited, and that of the giver of the benefit is credited. Alternatively, the discount allowed may be regarded as an expense or loss to the business, and a profit to the debtor. Similarly, discounts received by the business are credited to the Discount Account, and debited to the

creditors' accounts, since the business yields, and the creditors receive, the benefit of prompt payment. The amount of the discount is a gain to the business and a loss or expense to the creditor.

Cash discount must be distinguished from trade discount.

TRADE DISCOUNT is an allowance made by a manufacturer or wholesaler to a trader who has to resell the goods, and usually takes the form of a fixed or graduated percentage off the list price of the articles sold. It varies greatly in different trades, and often also on different articles, or on different quantities, in the same trade, and frequently represents the whole or a substantial part of the purchaser's profit on reselling the goods. Trade discount is granted without regard to the time when the cash is paid, and is normally deducted on the invoice for the goods, and from the entry in the sales day book, so that the purchaser's account in the ledger is debited and Sales Account credited with only the net amount. Similarly, in the purchaser's books, only the net amount of the purchase, after trade discount has been deducted, is entered in the bought day book and posted to the credit of the seller's account.

Illustration

CASH BOOK

Date	Particulars	Folio	Discount	Detail	Bank	Date	Particulars	Folio	Discount	Detail	Bank
19..			£	£	£	19..			£	£	£
Jan. 1	To Balance b/d.				400	Jan. 1	By F. Robertson		4		196
	„ J. Jones ..		2	98			„ Sundries:				
	„ F. Smith ..		1	49			Salaries ..			15	
					147		Petty Cash			5	
											20
							„ Balance c/d.				331
			£3		£547				£4		£547
Jan. 1	To Balance b/d.				331						

Note. – The account of J. Jones will be *credited* with £100 and that of F. Smith with £50, whilst Discount Allowed Account will be *debited* with £3. The account of F. Robertson will be *debited* with £200, Salaries Account with £15 and Petty Cash Account with £5, whilst Discount Received Account will be *credited* with £4.

(b) Form of Cash Book for mixed Cash and Bank transactions

In small businesses it is often found that some cash takings are applied in paying for purchases and expenses, only the balance being banked. When this is done, the cash book should have columns on either side for *Cash* and *Bank*, the *Cash* columns representing, in effect, the ledger account for cash and the *Bank* columns the ledger account with the bank. All amounts received, whether in the form of notes, coin or cheques, should be entered on the debit side in the *Cash* column, whilst payments should be entered on the credit side, in the *Cash* column, if made by cash, and in the *Bank* column if made by cheque. When cash is paid into the bank the double entry must be completed within the cash book itself, by crediting the *Cash* column and debiting the *Bank* column. Similarly, when it becomes necessary to draw cash from the bank, the *Bank* column must be credited and the *Cash* column debited. The balance of the *Cash* column, at any time, will represent the cash in hand, and can be checked therewith; the balance of the *Bank* column will indicate the balance standing to the credit of the business, or overdrawn, as the case may be, at the bank.

Illustration

On 1st January, the following amounts were received:
Cheque from J. Jones £20; Discount allowed £1.
Cash from F. Smith £40; Discount allowed £2.
Dividend on investment paid direct to Bank £10.

and the following payments were made:
Paid T. Robinson by cheque £33; Discount allowed £2.
Drew £20 from Bank for cash.
Paid Wages £18 from cash.
Private drawings of partner £10, from cash.
Paid £65 to Bank.

Record the above transactions in a convenient form of cash book, the commencing balances being £25 cash in hand and £300 at the bank.

CASH BOOK

Date	Particulars	Folio	Discount	Cash	Bank	Date	Particulars	Folio	Discount	Cash	Bank
19..			£	£	£	19..			£	£	£
Jan. 1	To Balances b/d.			25	300	Jan. 1	By T. Robinson		2		33
	„ J. Jones ..		1	20			„ Cash ..	Contra			20
	„ F. Smith ..		2	40			„ Wages ..			18	
	„ Div. from Investment ..				10		„ Drawings ..			10	
	„ Bank ..	Contra		20			„ Bank ..	Contra		65	
	„ Cash ..	Contra			65		„ Balances c/d.			12	322
			£3	£105	£375				£2	£105	£375
	To Balances b/d.			12	322						

In large businesses, cash receipts are often recorded by one or more clerks, and cash payments by others, separate cash books being employed for receipts and payments respectively. Periodically (*e.g.*, daily, weekly or monthly) the totals of these books are entered in a Total Cash Account kept either in the impersonal ledger or in a separate book. If this book is under the control of a senior official it enables secrecy to be maintained, so far as the ordinary staff is concerned, as to the cash position of the business.

The volume of transactions of the business may necessitate several cash received books being kept, *e.g.*, one for each department, and an efficient system of control, in such cases, is indispensable.

Again, it may be desired to deal with such confidential payments as directors' fees, managers' salaries, partners' drawings, etc., separately from the routine expenditure, and in such cases it is customary to have a private cash book with a separate bank account, sums being transferred periodically to this account from the general bank account.

(c) The Bank Reconciliation Statement

It rarely happens that the balance of the cash book agrees exactly, at any given date, with the balance shown by the bank pass book or statement. The difference may be attributable to any of the following causes:

(1) Cheques drawn and credited in the cash book may not yet have been presented to the bank for payment.

(2) Cheques paid into the bank for collection and debited in the cash book, may not have been credited by the bank.

(3) Payments made by or to the bank against bankers' orders may not have been entered in the cash book.

(4) Dividends, bills receivable, etc., collected by the bank may not have been entered in the cash book. Similarly, bills payable may have been paid by the bank, but not yet entered in the cash book.

(5) Bank interest and charges entered in the pass book or statement may not have been entered in the cash book.

(6) Cheques dishonoured may not have been re-presented or, if re-presented, may have been returned unpaid, and debited to the account by the bank, but not yet entered in the cash book.

It is necessary, therefore, to complete the writing up of the cash book in respect of any items not yet recorded therein, and then to prepare a reconciliation statement between the final cash book balance and the balance shown by the bank statement. Having checked entries in the cash book against those in the bank statement, the items not ticked on either side of the cash book will represent those not yet passed through the bank. The items not credited by the bank should be added to the balance shown on the bank statement, and the cheques outstanding deducted, unless the account is overdrawn, when the items not credited by the bank will be deducted from, and the cheques outstanding added to the balance shown by the bank statement. The balance should then equal the balance shown by the cash book.

Illustrations

(1) On checking the bank statement with the cash book, it was found that the balance standing to the credit of the business at the bank was £722, whereas there was a balance (*Dr.*) on the cash book of £700. Cheques paid in, but not yet credited by the bank were: Black £40, White £60; and cheques drawn in favour of the following persons had not yet been presented for payment: Jones £20, Smith £32, Robinson £70. Prepare the reconciliation statement.

RECONCILIATION OF BANK STATEMENT WITH CASH BOOK

	£	£
Balance as per Bank Statement		722
Add Amounts not credited – Black	40	
White	60	
		100
		822
Less Cheques outstanding – Jones	20	
Smith	32	
Robinson	70	
		122
Balance as per Cash Book		£700

(2) Assuming the facts as in the previous illustration, with the exception that the balance at the bank was £6, and the *overdraft* as per Cash Book £16, the statement would be as follows:

BANK RECONCILIATION STATEMENT

	£	£
Balance at Bank per Bank Statement ..		6
Add Amounts not credited – Black ..	40	
White ..	60	
		100
		106
Less Cheques outstanding – Jones ..	20	
Smith ..	32	
Robinson	70	
		122
Overdraft as per Cash Book ..		£16

§ 7. The Petty Cash Book

Petty cash transactions may most conveniently be recorded in a columnar petty cash book, an example of which is given below. Receipts of cash are entered in the receipts column (the *Bank* column in the general cash book being credited); whilst payments are entered first into a total payments column, and then extended into subsidiary columns analysed under the most convenient headings. The totals of the various analysis columns are posted at each balancing period to the debit of the respective impersonal accounts, with the exception of that of the *Ledger* column, which is reserved for all items for which there is no specific analysis column. These items are posted in detail to the appropriate accounts. This form of petty cash book obviates the necessity of posting each payment separately to the ledger.

When an analysed petty cash book is used there is no necessity to keep a petty cash account in the impersonal ledger, as the petty cash book is itself a ledger account and forms part of the double entry. Frequently, however, a Petty Cash Account is opened in the impersonal ledger, and all amounts paid to the petty cashier are debited thereto. At regular intervals the totals of the analysis columns of the petty cash book are entered on the credit side of the Petty Cash Account from which postings are made to the various expense accounts. In this manner the petty cash book becomes merely a memorandum book, and forms no part of the double entry.

Illustration (1)

PETTY CASH BOOK

Receipts	Folio in Cash Book	Date	Particulars	Voucher Number	Total Payments	Travelling Expenses	Stationery	Postage	Sundry Expenses	Ledger	Folio
£ s. d.		19..			£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	
10 0 0	31	Jan. 1	Cash								
			Envelopes	1	12 0		12 0				
			J. Jones – Bristol Expenses	2	3 10 6	3 10 6					
		2	Postage		2 0 0			2 0 0			
			Office Furniture – Stoc	3	12 6					12 6	27
			Cleaning Carpets ..	4	17 6				17 6		
					7 12 6	3 10 6	12 0	2 0 0	17 6	12 6	
			Balance c/d.		2 7 6	L. 49	L. 25	L. 19	L. 81		
£10 0 0					£10 0 0						
2 7 6		3	Balance b/d.								

THE IMPREST SYSTEM OF KEEPING PETTY CASH

The imprest system is a method of keeping cash or petty cash, whereby the cashier is provided with a fixed sum, and at each balancing period is given a cheque for the exact amount of his disbursements, thus restoring the petty cash balance to the original figure. The amount of the periodical disbursements is thus kept prominently before the notice of a responsible official.

The system is of particular utility where the petty cashier is a separate individual from the cashier. The petty cash book, whether it forms part of the double entry or is merely a record book, should always be thoroughly checked when expenditure is reimbursed, and ruled off or initialled up to that point. If proper supervision is exercised over the petty cashier, the responsible official can always call upon him to produce vouchers for unreimbursed expenditure which, together with the cash in hand, should equal the amount of the imprest. This may have the effect of saving a considerable amount of the responsible official's time, as he will always know what amount ought to be accounted for.

Where the imprest system is employed, the posting may be effected either from the petty cash book or from a Petty Cash Account, as already explained. Alternatively, it is sometimes considered desirable to keep the petty cash book outside the system of double entry, while dispensing with the Petty Cash Account, and where this is done the details of the expenditure for which a cheque is drawn or cash paid to reimburse petty cash are entered inset in the cash book and posted from it to the appropriate accounts. A petty cash float account will be required, but the balance thereon will remain constant.

Illustration (2)

Assume that the details shown in the Illustration on p. 10 are amended as follows:

The Petty Cash Account was started on 1st January with a cheque for £10 to form the 'float'. The petty cash book is outside the double entry, details of expenditure being entered in the cash book as and when reimbursed to petty cash.

The entries in the cash book would be as follows

CASH BOOK

			Fol.	£ s. d.	£ s. d.
	19 .				
	Jan. 1	By Petty Cash Float ..	L.18		10 0 0
	„ 3	„ Petty Cash:			
		Travelling Expenses	L.49	3 10 6	
		Stationery ..	25	12 0	
		Postage . ..	19	2 0 0	
		Sundries ..	81	17 6	
		Office Furniture:			
		Stool ..	27	12 6	
					7 12 6

The £10 would be debited to Petty Cash Float Account and would remain as a balance thereon. At balancing dates, petty cash would be reimbursed its expenditure to date in order to enable the postings to be completed from the cash book. No postings from the petty cash book would be necessary.

§ 8. Day Books

The most important day books are those used for purchases, sales, returns inwards and returns outwards.

The following is a suitable ruling for a simple form of purchases day book:

PURCHASES DAY BOOK

Date	Invoice No.	Particulars	Ledger Folio	Amount
19..		1st January, 19..		£ s. d.
Jan 1	18	A. Wilson	W. 62	44 16 0
	19	J. Smith	S. 104	50 0 0
	20	A. Lucas	L. 22	18 0 0

The particulars of entries in the purchases day book are obtained from the invoices received in respect of the goods purchased. Invoices should be numbered and filed in numerical order, the serial number of each invoice being entered in the appropriate column in the purchases day book. No difficulty should then be experienced in referring to any invoice, if it becomes necessary, for particulars of the purchase.

It is sometimes convenient to have separate day books for alternate days, to facilitate posting to the ledger.

The amount of each item in the purchases day book is posted to the *credit* of the account of the supplier. Periodically the purchases day book is cast, and the total posted to the *debit* of Purchases Account.

The sales day book, returns inwards book and returns outwards book are in similar form, the double entry in the ledger being effected as follows:

Sales Day Book.
Debit each sale to the personal account; *credit* periodical totals to Sales Account.

Returns Inwards Book.
Credit each return to the personal account; *debit* periodical totals to Returns Inwards Account.

Returns Outwards Book.
Debit each return to the personal account; *credit* periodical totals to Returns Outwards Account.

Separate day books may also be kept for allowances, commissions, fees, bills receivable and bills payable, and other purposes, according to the needs of the business.

Columnar Day Books

It is frequently convenient to have a form of purchases day book that will record all inward invoices, whether they relate to purchases or expenses.

A *Total* column is provided, and as many subsidiary columns as are necessary in the circumstances. The amount of each invoice is entered in the *Total* column (from which it is posted to the credit of the creditor's account), and extended into the proper subsidiary column or columns. The totals of these columns are posted periodically to the debit of the respective impersonal accounts, thereby obviating the necessity of posting each item separately to the impersonal ledger.

The following is a suitable ruling for such a book:

COLUMNAR PURCHASES DAY BOOK

Date	Invoice No.	Particulars	Fo.	Total	Purchases	Freight	Trade Exps.	Ledger	Fo.

The ledger column is used for items for which no special column is provided. Items in this column are posted in detail and not in total.

Similar forms can be used for sales day books, returns books and the like, where it is desired to analyse the items under different headings, *e.g.*, classes of goods, departments, travellers, ledgers, etc.

§ 9. The Journal

Since the vast majority of transactions are capable of being assigned to one or other of the day books, or special journals, the use of the journal (or 'journal proper') is now confined to such items as:

(1) The purchase and sale of fixed assets, where columnar purchases and sales book are not kept;

(2) Transfers from one account to another;

(3) Corrections and adjusting entries;

(4) Opening and closing entries.

Unlike a day book, from which all items have to be posted to the same impersonal account, thus enabling the total of such items to be posted in one sum periodically, the entries in the journal relate to transactions of miscellaneous kinds, and do not lend themselves to collective posting. The journal is therefore provided with debit and credit columns to correspond with the sides of the ledger. Entries in the debit column of the journal are posted to the debit side of the ledger, and entries in the credit column of the journal to the credit side of the ledger.

There should be appended to each entry in the journal, an explanation of the transaction, or *narration*, without which the origin of, and reason for, the entry might not be apparent. The narration should contain full information as to the nature of the transaction and the dates of contracts, minutes, resolutions, etc. giving rise to it, so that the authority for the transaction as well as the origin of the entry will be shown.

A journal entry shows first the name of the account to be debited, with the amount

in the debit column. The name of the account to be credited follows on the next line (the amount being entered in the credit column), prefixed by the word 'To', as indicating that the first account is indebted to, *i.e.*, has received from, the second, the value entered in the cash columns. Sometimes a journal entry will be a composite one, in which more than one account is debited or credited. The totals of the debits and credits must, however, be equal in amount.

Illustrations

(1) Record by journal entry purchase of Gas Engine, £600, from B. Jones & Co.

JOURNAL

			£	£
Plant and Machinery Account	*Dr.*	P.L. 3	600	
To B. Jones & Co.		B.L. 27		600
Being purchase of one Gas Engine.				

Note. – From the above entry £600 will be posted to the debit of Plant and Machinery Account and £600 to the credit of B. Jones & Co.

(2) Record by journal entry transfer of £50 from B. Jones & Co.'s account in the bought ledger to their account in the sales ledger, to set off a purchase against a sale.

JOURNAL

			£	£
B. Jones & Co.	*Dr.*	B.L. 27	50	
To B. Jones & Co.		S.L. 22		50
Being balance of Bought Ledger Account transferred to Sales Ledger on contra account.				

Note. – B. Jones & Co's. account in the bought ledger is debited and their account in the sales ledger credited, thereby setting off the purchase against the sale.

(3) Record by journal entry interest at 5 per cent. per annum for one year on A. & F. Smith's capitals of £1,000 and £500 respectively.

JOURNAL

			£	£
Interest on Capital Account	*Dr.*	P.L. 64	75	
To Current Accounts—				
A. Smith – 5% on £1,000		P.L. 10		50
F. Smith – 5% on £500		P.L. 15		25
Being interest at 5 per cent. per annum for the year ended 31st December, 19.., on Partners' Capitals.				

Note. – Interest on Capital Account is debited with £75, A. Smith's Current Account being credited with £50 and F. Smith's with £25.

(4) Record by journal entry the opening entries of B. Smith, who started business on 1st January, 19.., with the following assets and liabilities:

	£
Sundry Debtors	200
Bills Receivable	100
Cash at Bank	500
Stock	800
Sundry Creditors	150
Bills Payable	50

JOURNAL

			£	£
19.. Jan. 1	Sundries: To Sundries:	Dr.		
	Sundry Debtors		200	
	Bills Receivable		100	
	Stock		800	
	Cash		500	
	Sundry Creditors			150
	Bills Payable			50
	B. Smith: Capital Account			1,400
	Being Assets, Liabilities and Capital at this date.			
			£1,600	£1,600

Note. – The above entry is necessary to open the books of B. Smith's business on double entry principles. Each asset received by the business is debited to the appropriate asset account, and each liability credited to the appropriate liability account. The excess of the aggregate amount of the assets over that of the liabilities represents the value which the business has received from the proprietor, B. Smith, *i.e.*, the capital which he has invested in the business, and is credited to his Capital Account.

(5) How would the following errors in the books of a business affect the accounts? Show corrective journal entries:

£35	0	0	for goods sold to H. Jones posted to the debit of General Expenses Account.
63	1	2	cash posted to the credit of H. Brown, a partner, instead of to H. Brown, a customer.
12	1	9	posted to Office Expenses Account for the purchase of a safe.
1	5	6	posted to debit of Stationery Account, instead of to T. Wildsmith in payment of his account.
39	1	7	for wages to workmen for erecting the firm's new machinery, charged to Wages Account.
30	0	0	cost of repairing roof of a shed, charged to Buildings Account.

JOURNAL

		£ s. d.	£ s. d.
H. Jones	Dr.	35 0 0	
To General Expenses Account			35 0 0
Being transfer to H. Jones of amount debited in error to Expenses.			
H. Brown, Current Account	Dr.	63 1 2	
To H. Brown (Sales Ledger)			63 1 2
Being transfer to customer of amount posted in error to credit of H. Brown's Current Account.			
Office Furniture Account	Dr.	12 1 9	
To Office Expenses Account			12 1 9
Being transfer to Furniture Account of cost of Safe charged in error to Office Expenses.			
T. Wildsmith	Dr.	1 5 6	
To Stationery Account			1 5 6
Being transfer of amount posted in error to Stationery Account.			
Plant and Machinery Account	Dr.	39 1 7	
To Wages Account			39 1 7
Being Wages incurred in erecting new Machinery.			
Repairs Account	Dr.	30 0 0	
To Buildings Account			30 0 0
Being cost of repairing roof of Shed charged in error to Buildings Account.			

The rectification of these errors will increase the profit by £57 8s. 10d. as follows:

Decreased debits on nominal accounts—

	£	s.	d.
General Expenses	35	0	0
Office Expenses	12	1	9
Stationery	1	5	6
Wages	39	1	7
	87	8	10
Less Increase in Repairs	30	0	0
Increase in Profit..	£57	8	10

§ 10. The Ledgers

Hitherto the ledger has been referred to as one book, and in a small business it is possible that all ledger accounts could be accommodated in one volume. In a business of any size, however, it is necessary for the ledger to be subdivided, because of the large number of accounts, and also to enable a number of clerks to be engaged in posting to ledger accounts at the same time.

In a trading business it is usual to have a sales ledger, a bought ledger and a nominal or impersonal ledger. Further subdivision may be necessary, according to the size and requirements of the business. For example, the sales ledger may be divided into a number of books, each containing accounts of customers whose names begin with a particular letter, or a letter within a particular group. Thus there may be a ledger for names commencing with any of the letters A to G, another for names commencing with H to O, and another for P to Z. Alternatively, the ledgers may be divided according to geographical areas, or departments, or agencies. The bought ledger may be similarly divided.

The impersonal ledger may contain all the real and nominal accounts. This ledger may, however, be divided into a nominal ledger and a private ledger, the latter containing partners' capital and current accounts, loan accounts, investment accounts and any other accounts of a private and confidential character.

Loose Leaf and Card Ledgers

Within recent years the use of loose-leaf and card systems of ledgers has become increasingly familiar, and in most cases there can be no doubt that the advantages to be derived from such systems are considerable.

A *Loose-leaf ledger* is one, the leaves of which are not bound together in the ordinary way, but are inserted in binders with a locking mechanism in such a manner that they can be withdrawn, or new leaves inserted, by a very simple operation.

A *Card ledger* consists of a number of cards, one for each ledger account, which are filed away in alphabetical order in cabinets. As the cards have to be withdrawn from the cabinets for entries to be made on them, it is not possible to take the same precautions against substitution as in the case of loose-leaf ledgers, where the key of the

ledger can be kept under the control of some responsible official. The card system should therefore not be utilised unless strict supervision is enforced.

The card system is employed to a large extent for statistical records, such as stock accounts, cost accounts, etc., and for the analysis of sales over various zones or divisions. It has been very usefully employed in the case of a stockbroker's business, for the purpose of analysing the purchases and sales made on behalf of each client, so that a partner, desiring to ascertain the transactions that any particular client has been concerned in, has only to call for the card in question, when the full record of the transactions can be seen at a glance.

The following are other advantages to be derived by the adoption of these systems:

(1) The ledgers are continuous, inasmuch as additional pages or cards can be inserted as required, and it is therefore unnecessary to open new ledgers altogether at any one time. Moreover, all leaves relating to one person can be kept together, which is usually impossible in a bound ledger, no matter how carefully it is 'spaced out' when opened.

(2) Closed and dead accounts can be withdrawn from the ledger, and filed separately. This avoids the necessity of keeping such a large number of accounts in the current ledgers.

(3) For the purposes of extracting balances, preparing statements, or checking postings, the sheets or cards can, if necessary, be divided between a number of clerks.

The disadvantages of these systems are as follows:

(1) As additional leaves are inserted as required, the ledgers cannot be folioed in the ordinary manner, although this can be done to a partial extent under the heading of each letter.

(2) The possibility of sheets or cards being accidentally lost or destroyed, and, in the case of cards, being misplaced in the cabinets after use. This disadvantage is overcome by a sound system of internal check.

(3) There is a danger of a fraudulent substitution of one sheet or card for another, in order to conceal defalcations; or sheets or cards might be destroyed intentionally for a similar reason. Again the internal check should obviate these possibilities.

(4) It has been contended that loose-leaf or card ledgers might not be admitted as sufficient evidence in a court of law, owing to the possibility of substitution, but this need not be regarded as a serious disadvantage, since in any case some additional evidence for the entry would usually be required, apart from the record in the ledger.

Section 436 of the Companies Act, 1948, provides that any register, index, minute book or book of account required to be kept by a company may be kept either by making entries in bound books or by recording the matters in question in any other manner. Where bound books are not used, adequate precautions must be taken for guarding against falsification and facilitating its discovery, and where default is made in complying with this requirement, every officer of the company who is in default may be liable to a fine not exceeding £50, and to a default fine.

§ 11. The Trial Balance

A Trial Balance is a list of all the balances standing on the ledger accounts and cash books of a concern at any given date. It is clear that if a debit and a credit have been made in respect of every transaction, in the absence of clerical errors the total of the debits should equal the total of the credits, and if the accounts are balanced off, and the balances carried down, the total of the debit balances should equal the total of the credit balances.

Although the agreement of the two sides of a Trial Balance provides *primâ facie* evidence of the accuracy of the book-keeping, it is not conclusive proof of the absence of error, since mistakes of the following types would not cause a disagreement in a Trial Balance:

(1) The complete omission of a transaction, neither a debit nor a credit being made.

(2) Posting to the correct *side* of the ledger but to the wrong account.

(3) Compensating errors, *e.g.*, errors on one side of the ledger compensated by errors of the same amounts on the other side; or underpostings on one side compensated by overpostings on the same side.

(4) Errors of principle, *e.g.*, where transactions have been dealt with in a fundamentally incorrect manner, such as revenue expenditure treated as capital, or *vice versa.*

§ 12. The Trading and Profit and Loss Account

In order to ascertain the profit or loss made during a period, where books are kept by double entry, it is necessary, on the final date of the period, to transfer the balances of the nominal accounts to a Profit and Loss Account, in which the expenses and losses are set against the gains to show the net profit or loss.

Where the business comprises the buying and selling of goods, the Profit and Loss Account is normally divided into three sections, *viz.*, Trading Account, Profit and Loss Account, and Appropriation Account.

The object of the Trading Account is to find the amount of the gross profit on sales, *i.e.*, the excess of the realised proceeds of goods sold over their cost.

The TRADING ACCOUNT is debited with the value of the stock of goods on hand at the commencement of, and with the purchases of goods during, the period; and in the case of a manufacturing business where no separate Manufacturing Account is prepared, with the expenses of manufacturing goods and of placing them in a saleable condition. It is then credited with the sales, and with the value of the closing stock, computed upon a proper basis. Alternatively, the value of the closing stock may be deducted from the sum of the purchases and opening stock on the debit side of the account, thus revealing the cost of the goods sold.

The bringing into account of the closing stock is important. If the account dealt with quantities only, the stock on hand at the commencement, plus the purchases, would exactly equal the sales plus the stock on hand at the end. Generally, however, the Trading Account deals only with values, and not with quantities, though strictly the quantities are presumed to balance in the manner indicated. The Trading Account,

having been debited with the opening stock and with all purchases for the period, must be credited with the goods remaining unsold, valued at cost or market value (if lower) in order that the cost of goods which *have* been sold may be ascertained. The excess of the amount of the sales over this figure is the gross profit. The double entry for the closing stock credited to Trading Account is completed by debiting Stock Account, which represents an asset at the closing date. In effect, the Trading Account, which has been debited with all the goods received during the period, gives back into the Stock Account the goods which have not been sold, and is accordingly credited therewith.

It is important, as regards any trading business, to value the stock on hand at the date of balancing accounts on a correct basis. Particulars of the stock should be taken and listed in a systematic manner, and each item valued at the lower of its actual cost or market value at the date of the valuation.

The principles which should be observed in valuing stock-in-trade are fully considered in a memorandum issued by the Council of the Institute of Chartered Accountants, the text of which is given hereunder:

THE VALUATION OF STOCK-IN-TRADE

No particular basis of valuation is suitable for all types of business, but, whatever the basis adopted, it should be applied consistently, and the following considerations should be borne in mind:

(*a*) Stock-in-Trade is a current asset held for realisation. In the balance sheet it is, therefore, usually shown at the lower of cost or market value.

(*b*) Profit or loss on trading is the difference between the amount for which goods are sold and their cost, including the cost of selling and delivery. The ultimate profit or loss on unsold goods is dependent upon prices ruling at the date of their disposal, but it is essential that provision should be made to cover anticipated losses.

(*c*) Inconsistency in method may have a very material effect on the valuation of a business based on earning capacity, though not necessarily of importance in itself at any balance sheet date.

The following interpretations are placed on the terms 'cost' and 'market value':

(*a*) 'COST'

The elements making up cost are (i) the purchase price of goods, stores and, in the case of processed stock, materials used in manufacture; (ii) direct expenditure incurred in bringing stock-in-trade to its existing condition and location; and (iii) indirect or overhead expenditure incidental to the class of stock-in-trade concerned.

Whereas the cost of (i) and (ii) can be ascertained with substantial accuracy, (iii) – indirect or overhead expenditure – can only be a matter of calculation. If (iii) is expressed as a percentage of actual production, the amount added to the stock valuation will fluctuate from one period to another according to the volume produced. To avoid distortion of revenue results, in some cases indirect or overhead expenditure is eliminated as an element of cost when valuing stock-in-trade or, alternatively, only that part which represents fixed annual charges is excluded. In other cases, an amount is included which is based on the normal production of the unit concerned.

The following are bases usually adopted in practice for calculating cost:

(1) '*Unit Cost*'

Upon this basis, each article, batch or parcel is valued at its individual cost.

In certain cases, such as bulk stocks, this method is not always capable of application and records, including the allocation of expenses, may become unduly complicated. Further, it may not be practicable to apply the method to partly processed stocks or finished products where the individual units lose their identity.

(2) '*First in, first out*' (FIFO)

This basis assumes that goods sold or consumed were those which had been longest on hand and that the quantity held in stock represents the latest purchases.

It has the effect of valuing unsold stock in a reasonably close relation to replacement price. In certain manufacturing or producing businesses, however, it is difficult to apply accurately through the various stages of manufacture or production.

(3) '*Average*' *Cost*

This basis entails averaging the book value of stock at the commencement of a period with the cost of goods added during the period after deducting consumption at the average price, the periodical rests for calculating the average being as frequent as possible having regard to the nature of the business.

It has the effect of smoothing out distortion of results arising from excessive, and often fortuitous, fluctuations in purchase price and production costs and is particularly suitable to manufacturing businesses where several processes are involved.

The bases referred to above are founded on the principle that 'cost' is an historical fact. In some cases, however, their application is unsuitable or impracticable owing to the nature of the business, and stock-in-trade is taken at a cost estimated by one of the following methods:

(4) '*Standard*' *Cost*

This basis entails valuing stock at a pre-determined or budgeted cost per unit. It is coming more into use, particularly in manufacturing or processing industries where several operations are involved or where goods are produced on mass production lines.

(5) '*Adjusted Selling Price*'

On this basis, an estimated cost is obtained by pricing stock at current selling prices and deducting an amount equivalent to the normal profit margin and the estimated cost of disposal.

Other methods of stock valuation are the 'base stock' method, which retains permanently certain basic stock at a fixed price not exceeding its original cost, and that known as 'last in, first out' (LIFO) which is based on the principle that profit or loss on trading is the difference between the price at which goods are sold and their replacement cost.

There is, however, only limited application of either of these methods in this country.

(*b*) 'MARKET VALUE'

The expression 'market value' is commonly interpreted as either:

(i) the price at which it is estimated that the stock can be realised either in its existing condition or as incorporated in the product normally sold after allowing for all expenditure to be incurred before disposal; or

(ii) the cost of replacing the stock at the accounting date.

In considering the merits of these alternative methods, regard must be had to the purpose for which stock-in-trade is held, namely, to sell either in its existing condition or as incorporated in a manufactured product. The fact that at the time of valuation the goods could have been acquired at a sum less than their cost only indicates that the expected profit

is less than it might have been had it been possible to acquire them at the accounting date – a possibility which often does not exist in view of the quantity held and of the fact that in many cases purchases have to be made for later delivery; the circumstance has not caused a trading loss but only indicates that the ultimate results under other conditions might have been better.

On the other hand, if at the time of the valuation it is clear that selling prices will not cover cost and expenses yet to be incurred before the goods are disposed of, provision is necessary to meet the anticipated loss.

When estimating the amount of the provision required to cover excess of cost over market value, the method employed may be either (i) to consider each article in stock separately, (ii) to group articles in categories having regard to their similarity or interchangeability or, (iii) to consider the aggregate cost of the total stock-in-trade in relation to its aggregate market value.

RECOMMENDATION

It is therefore recommended that:

(1) The basis of valuation for stock-in-trade should normally be the lower of cost or market value, calculated as in (2) and (3) below.

In certain businesses, such as tea or rubber producing companies and some mining companies, there is a general custom to value stocks of products at the price subsequently realised less only selling costs; if this basis is adopted, the fact should be clearly indicated in the accounts.

In the case of long-term contracts, the value placed on work-in-progress should have regard to the terms and duration of the contracts. If, after providing for all known contingencies, credit is taken for part of the ultimate profit, this fact should be indicated.

(2) Cost should be calculated on such a basis as will show a fair view of the trend of results of the particular type of business concerned. Indirect or overhead expenditure, if included as part of the cost of partly processed or finished products, should be restricted to such expenditure as has been incurred in bringing the stock-in-trade to its existing condition and location.

Stocks of by-products, the cost of which is unascertainable, should be valued at current selling price (or contracted sale price where applicable) after deducting expenses to be incurred before disposal. The cost of the main product should be reduced accordingly.

(3) Market value should be calculated by reference to the price at which it is estimated that the stock-in-trade can be realised, either in its existing condition or as incorporated in the product normally sold, after allowing for expenditure to be incurred before disposal. In estimating this price, regard should be had to abnormal and obsolete stocks, the trend of the market and the prospects of disposal.

If the value of stock-in-trade is calculated by reference to replacement cost, it should be described in the balance sheet as being 'at the lower of cost or replacement value', but in no case should it exceed market value as described above.

(4) For the purpose of estimating the amount of the provision required to reduce stock-in-trade below cost, it may properly be valued on the basis of the lower of its aggregate cost or of its aggregate market value. On the other hand, a more prudent and equally proper course is to take each item of stock (or each category group) and value it on the basis of the lower of its own cost or market value.

(5) Where goods have been purchased forward and are not covered by forward sales, provision should be made for the excess, if any, of the purchase price over the market value and should be shown as such in the accounts.

Note: Where goods have been sold forward and are not covered by stocks and forward purchases, provision should be made for the excess, if any, of the anticipated cost over sales value.

(6) Whatever basis is adopted for ascertaining cost or calculating market value, it should be such as will not distort the view of the real trend of trading results and should be applied consistently regardless of the amount of profits available or losses sustained. Any reduction in stock values which exceeds the provisions embodied in the above recommendations is a reserve and should be shown as such in the accounts.

In a later memorandum the Council of the Institute repeat that in certain types of business, such as tea and rubber producing companies and some mining companies, it is normal practice to bring stock into the balance sheet at the price subsequently realised, less the selling costs. This procedure has the advantage in businesses of this kind that the produce of the year is related to the eventual proceeds of its disposal. The fact that the procedure involves a confusion of dates (in that it brings into account profit which had not been realised on the balance sheet date) is offset by the fact that it results in a more understandable presentation of the affairs of this particular type of business, so long as the accounts indicate clearly the basis adopted.

In yet another memorandum, dealing with Accounting in relation to changes in the purchasing power of money, the Council of the Institute discuss the question as to whether the charge against profit for consumption of stock-in-trade should have regard to current values (i.e. values which take into account changes in the purchasing power of money) rather than to historical monetary cost. The following is an extract from this memorandum:

'Some advocates of the current value method suggest that the manner of charging consumption in current value should be left open for consideration in the special circumstances of each case, but that certain methods of valuing stock-in-trade, namely LIFO (last in, first out) NIFO (next in, first out) base stock and variants of these, should be recognised as means of achieving the desired end, and that whatever method is adopted should be indicated in the accounts.

'In a period of rising prices the effect of charging consumption of stock-in-trade on the basis of current values would be that the difference between the cost of an article and the higher amount for which it could be replaced at the time of its sale would not form part of the profit on the transaction. In a period of falling prices, when stock-in-trade could be replaced at less than its historical cost, the current value method could not be applied unless an additional charge were made to cover the excess of the historical cost over the current value. Whether prices are rising or falling, however, the difference between the cost of an article and its current value may often result to a much greater extent from market fluctuations in the prices of particular goods than from any general trend in the purchasing power of money. Such market fluctuations are an ordinary business hazard affecting profit or loss and their incidence on a particular business may be dependent to a considerable extent upon judgment in buying and on management generally, whereas under the current value method the effect of these fluctuations would be excluded in computing profits.'

Accordingly the Council recommend that historical cost should continue to be the basis on which profits shown by annual accounts are computed. Any amount set aside out of profits in recognition of the effects which changes in the purchasing power of money have had on the affairs of the business (including any amount to finance the increase in the cost of replacements, whether of fixed or current assets) should be treated as a transfer to reserve, and not as a charge in arriving at profits.

The PROFIT AND LOSS ACCOUNT is credited with the gross profit brought down from the Trading Account, and with any other items of income or gain, such as discounts receivable, rents receivable, income from investments, etc., arising during the period; and debited with all the expenses incurred in selling and distributing the goods, and in the general administration of the business. The balance of the Profit and Loss Account represents the net profit or loss for the accounting period, and is carried down to the APPROPRIATION ACCOUNT, in which appear also any balance brought forward from the previous period, and appropriations of profit in the form of transfers to reserves, and dividends, in the case of a company, or interest on capital and partners' salaries, in the case of a partnership. The balance of the Appropriation Account is transferred to the proprietor's Capital or Current Account, in the case of a sole trader, or divided between the partners, if the business is that of a partnership. In the case of company, it is carried forward and appears as a revenue reserve in the Balance Sheet.

The Profit and Loss Account of a non-trading concern, such as an investment or property company, is usually called a REVENUE ACCOUNT or an INCOME AND EXPENDITURE ACCOUNT.

§ 13. The Balance Sheet

A Balance Sheet is a classified summary of the balances remaining open in the ledgers after the balances of the nominal accounts have been transferred to the Profit and Loss Account, but including the balance of that account. The Balance Sheet shows the position of the undertaking at a given date, and does not relate to a period, so that such an expression as 'Balance Sheet for the year ended 31st December' is incorrect. It is essential for the items on a Balance Sheet to be arranged in such a manner as to afford a true and fair view of the state of affairs of the concern.

In effect, the Balance Sheet is a statement which shows in summarised form the capital employed in the business, and the various sources from which it is derived (*e.g.*, proprietors' capital, undivided profits and external liabilities), and the manner in which that capital is employed, *i.e.*, the various assets by which it is represented. For the purposes of the Balance Sheet the fixed assets are normally valued at cost, less any provision made for depreciation, and the current assets at cost or realisable value, whichever is the lower.

It is customary in England for the credit balances to be shown on the left-hand side of the Balance Sheet, and the debit balances on the right-hand side, although the statement or vertical form, illustrated in Chapter VIII, is being increasingly adopted.

Although there is no statutory order in which the items in a Balance Sheet must be marshalled, they should be grouped under suitable sub-headings in order to throw into relief the most important aspects of the financial position which the Balance Sheet is intended to present, and to render it intelligible even to a person unversed in accounts. In the case of limited companies, the best modern practice is exemplified by the specimen Balance Sheets reproduced in Appendix B. On the assets side, separate groupings and sub-totals are given of fixed assets, investments and current (or

floating) assets, full details being supplied of the various assets comprised in each group. On the liabilities side, the capital is shown first, reserves and undistributed profits being added thereto to disclose, in an extended total, the amount of the proprietors' interest in the net assets. Separate headings and sub-totals are then given of debentures and other long-term liabilities, provisions and current liabilities respectively. In some cases the total of the current liabilities is deducted from the total of the current assets, in order to reveal the net amount of the working capital at the disposal of the business.

Columns may also be provided to show the corresponding figures for the previous year. This is now compulsory in the case of companies registered under any of the Companies Acts.

§ 14. The Accounts of a Sole Trader

Illustration

Henry Williams commenced business on 1st February, with cash at bank £500. The following transactions took place during the month:

19..			£
Feb.	1.	Bought Goods from W. Martin	250
		Purchased Warehouse Fittings for Cash	40
,,	2.	Sold Goods to T. Crown	80
		Drew Cheque for Petty Cash	20
,,	3.	Paid W. Martin on Account	150
,,	4.	Sold Goods to W. Wilson	100
,,	5.	Received Cheque from T. Crown	77
		Allowed him Discount	3
,,	6.	Paid Wages	4
,,	8.	Bought Goods for Cash	30
,,	9.	Sold Goods to L. Robinson	170
,,	10.	Purchased Goods from F. Pearson	130
,,	11.	Paid W. Martin in settlement	95
		Allowed Discount by him	5
,,	12.	Paid Carriage on Goods Sold	2
,,	13.	Paid Wages	4
,,	14.	Bought Goods from W. Martin	150
		,, ,, for Cash	40
,,	16.	Sold Goods to W. Wilson	180
,,	17.	W. Wilson paid on Account	200
,,	18.	Purchased Goods from H. Wood	75
,,	19.	Sold Goods for Cash	80
,,	20.	Paid Wages	4
,,	21.	Sent Cheque to H. Wood	72
		Allowed Discount by him	3
,,	22.	Sold Goods to T. Crown	130
,,	23.	Bought Goods from W. Martin	240
,,	24.	Bought Goods for Cash	73
,,	25.	Sent Cheque on Account to W. Martin	200
,,	26.	Received from T. Crown on Account	100

19..		£
Feb. 27.	Paid Wages	4
„ 28.	Paid Electric Lighting Account	5
	Paid Rent	8
	H. Williams drew for personal use	15

Petty Cash Expenditure for the month was:

Purchases	£4
General Expenses	7
Carriage Outwards	3

Stock on Hand, £325.

Enter the above transactions in the proper books of prime entry and post to the Ledgers. Prepare Trial Balance, Trading and Profit and Loss Account and Balance Sheet.

CASH BOOK

Fo. 1

19..		Fo.	Discount	Cash	19..		Fo.	Discount	Cash
			£	£				£	£
Feb. 1	To Capital Account ..	I.L. 1		500	Feb. 1	By Warehouse Fittings ..	I.L. 11		40
„ 5	„ T. Crown ..	S.L. 1	3	77	„ 2	„ Petty Cash ..	I.L. 12		20
„ 17	„ W. Wilson ..	S.L. 2		200	„ 3	„ W. Martin ..	B.L. 1		150
„ 19	„ Sales ..	I.L. 3		80	„ 6	„ Wages ..	I.L. 5		4
„ 26	„ T. Crown ..	S.L. 1		100	„ 8	„ Purchases ..	I.L. 4		30
					„ 11	„ W. Martin ..	B.L. 1	5	95
					„ 12	„ Carriage ..	I.L. 6		2
					„ 13	„ Wages ..	I.L. 5		4
					„ 15	„ Purchases ..	I.L. 4		40
					„ 20	„ Wages ..	I.L. 5		4
					„ 21	„ H. Wood ..	B.L. 3	3	72
					„ 24	„ Purchases ..	I.L. 4		73
					„ 25	„ W. Martin ..	B.L. 1		200
					„ 27	„ Wages ..	I.L. 5		4
					„ 28	„ Lighting ..	I.L. 7		5
					„ 28	„ Rent ..	I.L. 8		8
					„ 28	„ Drawings ..	I.L. 2		15
					„ 28	„ Balance c/d. ..			191
			£3	£957				£8	£957
			Fo. 9					Fo. 9	
Mar. 1	To Balance b/d.			£191					

SALES DAY BOOK

Fo. 1

Date	Particulars	Fo.	Amount
19..			£
Feb. 2	T. Crown	S.L. 1	80
„ 4	W. Wilson	„ 2	100
„ 9	L. Robinson	„ 3	170
„ 16	W. Wilson	„ 2	180
„ 22	T. Crown	„ 1	130
			£660
			Fo. 3

PURCHASES DAY BOOK

Fo. 1

Date	Particulars	Fo.	Amount
19..			£
Feb. 1	W. Martin	B.L. 1	250
„ 10	F. Pearson	„ 2	130
„ 14	W. Martin	„ 1	150
„ 18	H. Wood	„ 3	75
„ 23	W. Martin	„ 1	240
			£845
			Fo. 4

IMPERSONAL LEDGER

HENRY WILLIAMS CAPITAL ACCOUNT

Fo. 1.

				19..			£
				Feb. 1	By Cash	C.B. 1	500

HENRY WILLIAMS CURRENT ACCOUNT

Fo. 2.

19..			£	19..			£
Feb. 28	To Cash	C.B. 1	15	Feb. 28	By Net Profit	I.L. 20	37
	„ Balance c/d		22				
			£37				£37
				Mar. 1	By Balance b/d.		22

SALES ACCOUNT

Fo. 3.

19..			£	19..			£
Feb. 28	To Trading Account	I.L. 20	740	Feb. 19	By Cash	C.B. 1	80
				„ 28	„ Sundries	S.D.B.1	660
			£740				£740

PURCHASES ACCOUNT

Fo. 4.

19..			£	19..			£
Feb. 8	To Cash	C.B. 1	30	Feb. 28	By Trading Account	I.L. 20	992
„ 15	„ „	„	40				
„ 24	„ „	„	73				
„ 28	„ Petty Cash	I.L. 12	4				
	„ Sundries	B.D.B.1	845				
			£992				£992

WAGES ACCOUNT

Fo. 5.

19..			£	19..			£
Feb. 6	To Cash	C.B. 1	4	Feb. 28	By Profit and Loss Account	I.L. 20	16
„ 13	„ „	„	4				
„ 20	„ „	„	4				
„ 27	„ „	„	4				
			£16				£16

CARRIAGE ACCOUNT

Fo. 6.

19..			£	19..			£
Feb. 12	To Cash	C.B. 1	2	Feb. 28	By Profit and Loss Account ..	I.L. 20	5
„ 28	„ Petty Cash	I.L. 12	3				
			£5				£5

LIGHTING ACCOUNT

Fo. 7.

19..			£	19..			£
Feb. 28	To Cash	C.B. 1	5	Feb. 28	By Profit and Loss Account ..	I.L. 20	5

RENT ACCOUNT

Fo. 8.

19..			£	19..			£
Feb. 28	To Cash	C.B. 1	8	Feb. 28	By Profit and Loss Account ..	I.L. 20	8

DISCOUNT ACCOUNT

Fo. 9.

19..			£	19..			£
Feb. 28	To Sundries	C.B. 1	3	Feb. 28	By Sundries	C.B. 1	8
	„ Profit and Loss Account ..	I.L. 20	5				
			£8				£8

GENERAL EXPENSES ACCOUNT

Fo. 10.

19..			£	19..			£
Feb. 28	To Petty Cash	I.L. 12	7	Feb. 28	By Profit and Loss Account ..	L. 20	7

WAREHOUSE FITTINGS ACCOUNT

Fo. 11.

19..			£				
Feb. 1	To Cash	C.B. 1	40				

PETTY CASH ACCOUNT

Fo. 12

19..			£	19			£
Feb. 2	To Cash	C.B. 1	20	Feb. 28	By General Expenses	L. 10	7
					„ Carriage	L. 6	3
					„ Purchases	L. 4	4
					„ Balance c/d		6
			£20				£20
Mar. 1	To Balance b/d.		6				

STOCK ACCOUNT

Fo. 13.

19..			£				
Feb. 28	To Trading Account	L. 20	325				

SALES LEDGER

T. CROWN

Fo. 1.

19..			£	19..			£
Feb. 2	To Goods	S.D.B.1	80	Feb. 5	By Cash and Discount ..	C.B. 1	80
,, 22	,, ,, ...	,,	130	,, 26	,, Cash	,,	100
				,, 28	,, Balance c/d.		30
			£210				£210
Mar. 1	To Balance b/d.		30				

W. WILSON

Fo. 2.

19..			£	19..			£
Feb. 4	To Goods	S.D.B.1	100	Feb 17	By Cash	C.B. 1	200
,, 16	,, ,, ...	,,	180	,, 28	,, Balance c/d.		80
			£280				£280
Mar. 1	To Balance c/d.		80				

L. ROBINSON

Fo. 3.

19..			£				
Feb. 9	To Goods	S.D.B.1	170				

BOUGHT LEDGER

W. MARTIN

Fo. 1.

19..				19			£
Feb. 3	To Cash	C.B. 1	150	Feb. 1	By Goods	B.D.B.1	250
,, 11	,, Cash and Discount ..	,,	100	,, 14	,, ,, ...	,,	150
,, 25	,, Cash	,,	200	,, 23	,, ,, ...	,,	240
,, 28	,, Balance c/d.	,,	190				
			£640				£640
				Mar. 1	By Balance b/d.		190

F. PEARSON

Fo. 2.

				19..			£
				Feb.10	By Goods	B.D.B.1	130

H. WOOD

Fo. 3.

19..			£	19..			£
Feb. 21	To Cash and Discount ..	C.B. 1	75	Feb.18	By Goods	B.D.B.1	75

TRIAL BALANCE
28TH FEBRUARY, 19..

Fo.			£	£
I.L.	1	Capital Account		500
,,	2	Current Account	15	
,,	3	Sales		740
,,	4	Purchases	992	
,,	5	Wages	16	
,,	6	Carriage	5	
,,	7	Lighting	5	
,,	8	Rent	8	
,,	9	Discount		5
,,	10	General Expenses	7	
,,	11	Warehouse Fittings	40	
,,	12	Petty Cash	6	
C.B.	1	Cash at Bank	191	
B.L.	1	W. Martin		190
,,	2	F. Pearson		130
S.L.	1	T. Crown	30	
,,	2	W. Wilson	80	
,,	3	L. Robinson	170	
			£1,565	£1,565

TRADING AND PROFIT AND LOSS ACCOUNT
FOR MONTH ENDED 28TH FEBRUARY, 19..

Fo. 20.

		£			£
To Purchases	L. 4	992	By Sales	L. 3	740
Less Stock at 28th Feb.	L. 13	325			
		667			
,, Balance, being Gross Profit c/d.		73			
		£740			£740
To Wages	L. 5	16	By Gross Profit b/d.		73
,, Carriage	L. 6	5	,, Discount	L. 9	5
,, Lighting	L. 7	5			
,, Rent	L. 8	8			
,, General Expenses	L. 10	7			
,, Net Profit, carried to Current Account	L. 2	37			
		£78			£78

BALANCE SHEET AS AT 28TH FEBRUARY, 19..

		£			£
H Williams:			Fixed Assets:		
Capital Account		500	Warehouse Fittings		40
Current Account:					
Net Profit	£37		Current Assets:		
Less Drawings	15		Stock	£325	
		22	Sundry Debtors	280	
		522	Cash at Bank	191	
			Cash in hand	6	
Current Liabilities:					802
Sundry Creditors		320			
		£842			£842

§ 15. Methods of dispensing with day books and personal ledgers

The imperative need, under modern conditions, of exercising the greatest economy in the field of business administration, as well as in production, is prompting more and more firms, even where a mechanised system of accounting has not been installed, to dispense with the use of day books and personal ledgers, and substitute therefor a

system under which original documents, or carbon copies thereof, are employed to serve the functions hitherto performed by these books of account. The following is an outline of such a system:

(a) Purchases and Expenses

(1) All suppliers' invoices and credit notes, after being checked as to quantity, description and price, are filed in a folder or other container, in alphabetical order. The greatest care must be taken to prevent the possibility of any being lost or mutilated.

(2) At the end of each month, all invoices and credit notes received from each individual supplier during the month are arranged in order of date, and checked with the statement of account rendered by him.

(3) Each supplier's invoices and credit notes for the month are then attached to his statement of account, and the whole produced to the director or principal for authentication, when the cheque in payment of the account is presented to him for signature.

(4) The Cash Book contains on the credit side analysis columns for purchases, capital expenditure, rent, rates, etc., and each principal classification of expenditure. Payments to creditors entered therein are numbered consecutively, the corresponding numbers being entered on the creditors' statements which, with the official receipts (if any) attached, are filed away in numerical order. Each payment is entered in the Cash Book in the total column and extended into the appropriate analysis column, the periodical totals of which are posted to the debit of the relevant accounts in the impersonal ledger.

This system can only be employed where accounts are settled at regular intervals, and the greatest care must be taken in filing the invoices and credit notes received, and in checking them with the creditors' statements, if it is to operate effectively. Where, for any reason, an invoice is not paid on its due date, it should be filed with the invoices for the following month, and a list should be made at the end of each month, of all invoices outstanding, so that none will be overlooked.

When preparing the profit and loss account and balance sheet at the end of an accounting period, the total amount of the invoices outstanding for purchases and other expenses, which have not yet been passed through the books, must be debited to the Purchases Account, or the relevant expense accounts, as the case may be, and carried down therein as a credit balance to the commencement of the new period. The accounts for the old period will thereby be charged with the whole of the expenditure incurred in respect of that period, whilst the credit balances carried down will represent outstanding liabilities, and will be included in the amount of the Sundry Creditors in the Balance Sheet. These credit items will automatically be balanced off when the accounts are paid and the postings made from the columnar Cash Book in the new period.

(b) Sales

In businesses where the transactions with individual customers are relatively few in

number and the payment of accounts within a short period of credit can be rigidly enforced, it may be possible to dispense altogether with a Sales Day Book and Sales Ledger, folders containing carbon copies of invoices, etc., taking the place of personal accounts.

Three copies of each sales invoice (or credit note) are prepared simultaneously, the first being sent to the customer, the second placed in the current folder or other receptacle maintained for him, and the third used in building up the total figures for posting to the impersonal ledger.

When the customer sends a remittance the invoices and credit notes discharged thereby are withdrawn from the folder and filed permanently. The balance owing by the customer at any time will thus be the sum of the invoices (less credit notes) remaining in the folder. (If desired, the amounts of all invoices, and credit notes issued to the customer may be entered on the inner page of the folder as a 'recapitulation statement'. When an account is paid, the amount of the remittance is deducted from the total amount due, the balance outstanding being thus clearly indicated.)

To enable the appropriate entries to be made in the impersonal ledger, detailed lists will be prepared (probably by means of an adding and calculating machine) of each day's sales invoices and credit notes, and the net total of sales (less credits) as computed by the machine, posted to the debit of the Debtors Control Account and to the credit of Sales Account. The daily totals of cash received and discounts allowed, as shown by the Cash Book, will be credited to the Debtors Control Account, the balance of which, at any time, will then be the total of the outstanding debtors for sales, and should be capable of reconciliation with the balances disclosed by the customers' folders.

CHAPTER II

TOTAL [OR CONTROL] ACCOUNTS AND SECTIONAL BALANCING

§ 1. Total [or Control] Accounts

A Total Account is an account to which are debited and credited in total all the transactions which have been debited and credited in detail to individual ledger accounts. A Total Account in respect of a particular ledger therefore operates as a control account for that ledger, since the balance of the Total Account at any time should equal the sum of the balances of all the individual accounts within that ledger, and will provide a check on the accuracy of such balances. Total Accounts are alternatively referred to as Control Accounts.

In a business of any magnitude, it is desirable to raise Total Accounts in respect of debtors and creditors ledgers for the following reasons:

(1) Since the balances of the Total Accounts at any time should represent the totals of the balances appearing in the debtors and creditors ledgers, if it is desired to prepare interim Profit and Loss Accounts and Balance Sheets, the balances of the Total Accounts can be entered in the Trial Balance, thus obviating the time and labour involved in extracting schedules of the balances of the individual Debtors' and Creditors' Accounts.

(2) If kept under the control of a responsible official, and not made accessible to the ledger clerks whose duty it is to post to the debtors and creditors ledgers, the Total Accounts operate as a control over those ledgers, and constitute a valuable feature of the system of internal check.

(3) Where the two sides of a Trial Balance do not agree, with the aid of Total Accounts the difference may be located to the particular ledger or ledgers in which the errors exist, and the work of checking can be confined to that ledger or ledgers, thus avoiding waste of time in balancing.

The Total Accounts may, if desired, be kept in the impersonal ledger, from which it will then be possible to extract a Trial Balance without reference to the personal ledgers, since the Total Accounts will provide the totals of the personal account balances. It is preferable, however, to keep the Total Accounts in a separate book under responsible control, so that a check can be imposed upon the personal ledgers, whilst making it unnecessary to expose the impersonal ledger to the clerk in charge of the Total Accounts.

(a) Total Debtors Account

This account is debited with the sum of all the items which have been debited in detail to individual personal accounts in the sales ledgers, and credited with the sum of all the items which have been credited to such accounts. The balance of the Total Debtors Account should therefore be equal to the sum of all the balances appearing in the sales ledgers.

It must be remembered, however, that the sales ledgers may contain a few accounts showing credit balances, and the balance of the Total Debtors Account will only represent the difference between the total of the debit balances and the total of the credit balances (if any) in the sales ledgers. When, therefore, the balance of the Total Account is agreed with the schedule of balances extracted from the sales ledgers, balances should be brought down on both sides of the Total Account, representing respectively the total of the debit balances and the total of the credit balances in those ledgers.

The Total Debtors Accounts will contain on the debit side the totals of:

(1) Opening debit balances.

(2) Sales made during the period.

(3) Dishonoured bills and cheques (if any).

(4) Cash paid to debtors (if any).

(5) Transfers and other items (if any).

and on the credit side:

(1) Opening credit balances (if any).

(2) Cash received from debtors during the period.

(3) Discounts allowed to debtors.

(4) Returns inwards, and allowances.

(5) Bills receivable.

(6) Bad debts written off.

(7) Transfers and other items (if any).

The opening balances will be brought down from the previous period, and will agree with the total of the last schedule of debtors.

The total amount of sales for the period will be obtained from the sales day book, the totals of which should be posted monthly or at other periodical intervals to the Total Debtors Account.

Dishonoured bills will be obtained from an analysis of the journal (*see* (*c*) *below*). This should not involve any serious difficulty, as the number of such items will probably not be great. Should any of the dishonoured bills have been discounted, the

entries debiting the personal accounts in the sales ledger will probably have been made direct from the cash book. In such cases the adjusting entries in the Total Debtors Account should have been made simultaneously with the cash postings. The whole of these dishonoured bill items can easily be checked, however, as the *Remarks* column in the bills receivable book should show at a glance all bills which have been discounted, and all which have been dishonoured.

The total amount of cash received from debtors which has been posted to the sales ledgers during the period will be obtained from the *Sales Ledger* column in the cash book and posted to the Total Debtors Account at monthly or other intervals.

Discounts allowed will be obtained from the totals of the *Discount* column on the debit side of the cash book, and from the *Cash Discount* column (if any) in the bills receivable book. Where no such column is provided in the bills receivable book, the discount will either have been entered in the *Discount* column in the cash book, or a separate journal entry will have been made for each item. In the latter case the total will be obtained from an analysis of the journal.

Returns inwards will be obtained from the totals of the sales returns book, which will be posted to the Total Debtors Account periodically. Allowances will be obtained from the analysis of the journal.

Bills receivable will be obtained from the total of the bills receivable book, which will be posted periodically to the Total Debtors Account.

The bad debts written off will be obtained from an analysis of the journal.

(b) Total Creditors Account

This account operates as a control account of the bought ledgers and should disclose a balance equal to the total of all the individual balances in those ledgers. The account is raised in a similar manner to the Total Debtors Account.

On the credit side will be found:

(1) The opening credit balances.

(2) Purchases during the period.

(3) Transfers and other items (if any).

and on the debit side:

(1) Opening debit balances (if any).

(2) Cash paid to creditors during the period

(3) Discounts received.

(4) Returns outwards.

(5) Bills payable.

(6) Transfers and other items (if any).

The opening balances will be brought down from the previous period, and will agree with the total of the last schedule of creditors.

The total amount of goods purchased during the period will be obtained from the purchases day book.

The total amount of cash paid to creditors during the period will be obtained from the *Bought Ledger* column in the cash book.

Discounts received will be obtained from the totals of the *Discount* column on the credit side of the cash book, and from the *Cash Discount* column (if any) in the bills payable book. If no such column is provided in the bills payable book, and the items have not been passed through the *Discount* column in the cash book, the total will be obtained from an analysis of the journal.

Returns outwards will be obtained from the totals of the purchases returns book.

Bills payable will be obtained from the totals of the bills payable book.

(c) Journal

In any system of Total Accounts it is essential to pass every item through a book of prime entry before posting it to the ledger. The journal is consequently of considerable importance for the purpose of recording those items for which no special book of prime entry is provided.

The following is a convenient ruling of a journal used solely to record transfers.

Illustration (1)

TRANSFER JOURNAL

Date	Amount to be debited	Folio	Amount	Folio	Amount to be credited	Date

Where there are not too many ledgers, the transfer journal may be incorporated in he ordinary journal, which may be ruled so that the required totals can be arrived at vithout additional analysis, as shown in the following illustration:

Illustration (2)

JOURNAL

Date	Particulars	Folio	Debits: Bad Debts	Debits: Sundries	Debits: Sales Ledgers A-K	Debits: Sales Ledgers L-R	Debits: Sales Ledgers S-Z	Debits: Bought Ledgers A-L	Debits: Bought Ledgers M-Z	Folio	Credits: Sundries	Credits: Sales Ledgers A-K	Credits: Sales Ledgers L-R	Credits: Sales Ledgers S-Z	Credits: Bought Ledgers A-L	Credits: Bought Ledgers M-Z
			£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.		£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.
July 15	Bad Debt – Jones ..		15 0 0									15 0 0				
	Transfer – Smith .						140 0 0									140 0 0
Dec. 31	Correction – drawings charged to Personal Account Mr. Brown ..			50 0 0								50 0 0				
	Allowance from B.M.X. Ltd.							10 0 0			10 0 0					

Illustration (3)

On 1st January, the sales ledger balances were £16,000 debit and £64 credit, and the bought ledger balances at the same date £8,760 credit and £59 debit.

During the six months ended 30th June, sales amounted to £46,000; purchases to £39,340; cash received from debtors £42,240; cash paid to creditors £39,552; discount allowable £1,760; discount receivable £1,648; returns inwards £850; returns outwards £620; bills receivable £1,780; bills payable £2,740; dishonoured Bills £190; discount allowed to debtors, but subsequently disallowed £10; bad debts written off £320; a debit balance in the bought ledger transferred to the sales ledger, £13.

The sales ledger balances at 30th June amounted to £15,208 debit and £9 credit; and the bought ledger balances to £3,559 credit and £65 debit.

Prepare from these particulars a Total Debtors Account and a Total Creditors Account, bringing down the balances as at 30th June, proving the correctness of the sales and bought ledgers respectively.

TOTAL DEBTORS ACCOUNT

		£			£
Jan. 1	To Balance b/d.	16 000	Jan. 1	By Balance b/d.	64
June 30	,, Sales	46,000	June 30	,, Cash	42,240
	,, Dishonoured Bills	190		,, Discount Allowable	1,760
	,, Discount disallowed	10		,, Returns Inwards	850
	,, Transfers	13		,, Bills Receivable	1,780
	,, Balance c/d.	9		,, Bad Debts	320
				,, Balance c/d.	15,208
		£62,222			£62,222
July 1	To Balance b/d.	15,208	July 1	By Balance b/d.	

TOTAL CREDITORS ACCOUNT

		£			£
Jan. 1	To Balance b/d.	59	Jan. 1	By Balance b/d.	8,760
June 30	,, Cash	39,552	June 30	,, Purchases	39,340
	,, Discount Receivable	1,648		,, Transfers	13
	,, Returns Outwards	620		,, Balance c/d.	65
	,, Bills Payable	2,740			
	,, Balance c/d.	3,559			
		£48,178			£48,178
July 1	To Balance b/d.	65	July 1	By Balance b/d.	3,559

Notes to Illustration.

The accuracy of the Total Accounts should be tested by drawing up a Trial Balance, including the balances on these accounts in lieu of the totals of the schedules of debtors and creditors. If this Trial Balance agrees it may be assumed that the Total Accounts are correct, but it is advisable to check all postings to the impersonal ledgers to avoid the possibility of compensating errors.

(d) Columnar Books

Where only a small number of personal ledgers is kept the books of prime entry should be ruled with columns to correspond with the personal ledgers in order to provide the totals of amounts posted to each ledger. In a case where there are two sales ledgers and one bought ledger the rulings shown in the following illustration would suffice.

Illustration

Dr. CASH BOOK Cr.

Date	Particulars	Folio	Discount	Details	Bank	Sales Ledger Town		Sales Ledger Country		Impersonal	Date	Particulars	Folio	Discount	Details	Bank	Purchases Ledger		Impersonal Ledger
						Discount	Amt.	Discount	Amt.	Amt.							Discount	Amt.	Amt.

SALES DAY BOOK

Date	Name	Particulars	Folio	Total	Sales Ledger	Sales Ledger
					Town	Country

PURCHASES DAY BOOK

Date	Name	Particulars	Folio	Amount

(e) Separate Day Books or Subsidiary Analyses

Where the number of ledgers is too large to make the above system of analysis practicable a different method must be employed. In some cases it may be advisable to keep a separate set of books of prime entry for each ledger, or for each group of ledgers. In the latter case, each book will be analysed in the manner set out above.

In other instances, it may be expedient to use only one set of books, but to prepare periodical analyses thereof on separate sheets. To facilitate this analysis, each ledger must be given a distinguishing letter or symbol, which should be entered in the folio column of the day book in respect of items posted to that ledger. This method is explained more fully in § 2 below.

Where the number of ledgers is considerable, it will usually be found that a system of machine accounting is employed, and the machines themselves will accumulate totals as postings proceed. These totals can be entered in the Total Accounts, thus obviating the necessity for analysis.

§ 2. Sectional Balancing or Self-balancing Ledgers

The separate proving of ledgers forms an important part of a system of control. Where none of the methods of analysis described above can conveniently be adopted the following scheme of sectional balancing may be used :

(1) A prime entry should be made for each transaction. No transfers from one ledger to another should be made without the entry first being passed through the journal. This rule should be most rigidly enforced, as otherwise great difficulty may be experienced in agreeing the balances of the particular ledger with the Total Account applicable to that ledger.

(2) In the books of prime entry posting references should be made as follows: Each ledger should be distinguished by a particular letter, which should be written boldly just outside the folio column in the book of prime entry in every posting reference to that ledger. The folio column will, of course, contain merely the page of the ledger concerned, and by glancing down the pages of any of the books of prime entry, the letters denoting the ledgers to which the postings have been made will be apparent.

(3) At the end of each month or other interval lists should be extracted of all the items posted to each ledger from each book of prime entry.

The totals of these lists referring to any book of prime entry should agree with the total of that book for the period.

(4) When such lists have been checked, the amounts thereof should be entered into a summary book, which should have a separate column or page for each ledger in use. The summary book will thus contain particulars of all the entries in the books of prime entry correctly analysed, so that, with the balances brought forward from the previous period, a Total Account will result for each ledger.

(5) The clerks who extract the ledger balances should have nothing whatever to do with the postings of those ledgers, and no ledger balances should be taken out by the clerk who prepares the analysis sheets for entry in the summary book.

(6) The summary book should be under the immediate control of a responsible official, and no ledger clerk should be allowed access to it.

Ledgers are commonly mis-named 'self-balancing' where counterparts of the Total Accounts in the impersonal ledger are kept in the personal ledgers themselves for the purpose of enabling an independent Trial Balance to be prepared from each ledger. The Total Accounts, being equal but opposite, cancel each other out in the Trial Balance of the books as a whole. This practice is, however, unnecessary and undesirable, as it not only involves the Total Accounts being prepared twice merely to serve a theoretical purpose but nullifies a valuable feature of the system of internal check, by making the total figures available to the ledger clerks.

The following is an illustration of a sales ledgers summary book, ruled for a business having five sales ledgers.

Illustration

SALES LEDGER SUMMARY BOOK

Date	Particulars	Ledg. A	Ledg. B	Ledg. C	Ledg. D	Ledg. E	Total	Date	Particulars	Ledg. A	Ledg. B	Ledg. C	Ledg. D	Ledg. E	Tot
19..								19..							
Jan. 1	To Balance b/f. ..							Jan. 1	By Balance b/f. ..						
" 31	" Sales ..							" 31	" Cash						
	" Dishonoured Bills								" Discount Allowed						
	" Discount ..								" Returns Inwards						
	" Transfers ..								" Bills Receivable						
	" Cash								" Bad Debts ..						
	" Balance c/d. ..								" Transfers ..						
									" Balance c/d. .						
	£														
19..								19..							
Feb. 1	To Balance b/d. ..							Feb. 1	By Balance b/d. ..						

Notes to Illustration.

A separate page in the summary book could be allotted to each ledger if desired.

The Total column will be found useful for purposes of checking with the monthly totals in the books of prime entry, and can be used as a Total Debtors Account.

§ 3. The Location of Errors

If it is found that the Trial Balance agrees when the balance of a Total Account is inserted, but that the list of ledger account balances does not agree with the balance of the Total Account for that ledger, it may be that there is a compensating error in the impersonal ledger. For example, if the Sales Account is overstated owing to an inaccurate addition in a day book, since the same inaccurate amount of sales will have been debited to the Total Debtors Account, the Trial Balance will agree, but the list of balances in the sales ledger will not agree with the balance of the sales ledger Total Account. In some instances it may be found that the Trial Balance would agree if the total of the schedule of balances were inserted instead of the balance of the Total Account. If such is the case, the error is *primâ facie* an omission of a total in posting to the Total Account, or the posting of an incorrect figure thereto.

If it is found that the total of the balances on a particular ledger does not agree with the balance of the Total Account relating thereto, the following steps should be taken to locate the cause of the difference:

(1) Check the additions of the books of prime entry relating to the ledger concerned, paying particular attention to 'carry forwards'.
(2) Check the analysis columns in all the books of prime entry.
(3) Re-check the postings to the Total Accounts.
(4) Check the postings made in the ledger.
(5) Re-check the balances extracted from the ledger.
(6) Re-cast the list of balances.
(7) Check the opening list of balances with the accounts in the ledger concerned, seeing that the balances are properly brought down.

If these steps fail to bring the error to light, it will be necessary to analyse the ledger and agree the totals of the books of prime entry with the analysis.

If the Trial Balance disagrees, apart from the Total Accounts, or if no Total Accounts are kept, the procedure for the discovery of the cause of difference will be on the following lines:

After the Trial Balance has been re-cast, it should be seen whether the amount of the error is capable of being interpreted as a mis-posting. Thus, if the difference is £4 5s. 2d., it may arise through £4 10s. 0d. being posted as 4s. 10d., and all items of that amount in the books of prime entry should be subjected to scrutiny.

If the amount of the error is divisible by two, it is possible either that a posting of half the amount has been made to the wrong side of the ledger, or that a balance of half the amount has been entered in the wrong column of the Trial Balance.

If these tests do not reveal the error, the balances should be re-checked in detail on to the Trial Balance.

If the error still remains undetected, the whole of the books of prime entry must be cast, and, if necessary, the postings to the ledger re-checked. All carry forwards must be watched, since transposed figures may be the cause of the discrepancy. In casting the ledgers, exceptional care should be taken to see that balances have been properly carried down, and that the accounts actually balance; and it may be necessary to check the opening balances from the previous Balance Sheet and schedules.

If Total Accounts have not been kept, these may, in the last resource, be compiled, and with their aid the error should certainly be located.

CHAPTER III

PROVISIONS AND RESERVES, DEPRECIATION, ETC.

§ 1. Definitions of Reserve, Provision and Reserve Fund

As will be seen in Chapter VIII, the definitions of the expressions 'provision' and 'reserve' given in the Companies Act, 1948, and required by that Act to be used in the accounts of limited companies, have modified the conception of these terms which had hitherto prevailed.

The expression 'provision' has in the past been employed to signify the provision made for accrued or anticipated liabilities, whilst the expression 'reserve' has been used to denote an amount set aside for some specific purpose, either as a charge in respect of or an estimate of a loss to be incurred, *e.g.*, a provision for bad debts, or as an appropriation for the general purpose of strengthening the business by way of conserving working capital. The terms have, however, often been regarded as interchangeable.

For the purposes of the Companies Act, 1948, the expression 'provision' means an amount written off or retained to provide for depreciation or diminution in value of assets, or retained to provide for a known liability, the amount of which cannot be ascertained with substantial accuracy. A 'reserve' must *not* include an amount set aside for any such purpose and must, therefore, by implication, represent undistributed profits, or surplus assets. In the interest of consistency, and to prevent confusion these interpretations of the expressions will be adopted throughout this work.

A 'Reserve Fund' is a reserve which is represented by investments outside the business. Sinking Funds for the repayment of loans, and Insurance Funds are instances of specific reserve funds.

It should be noted that there is a considerable diversity of opinion as to the exact meaning of the term Reserve Fund, and the expression is frequently used where there are no specific investments outside the business representing such fund. There can be no question, however, that the use of the word 'fund' is generally understood to imply the corresponding existence of assets of a readily realisable nature, and in the opinion of the authors the phrase should only be used where this is the case. This view has been endorsed by the Council of the Institute of Chartered Accountants in a recommendation to its members.

Provisions made against anticipated losses and contingencies are charges against profits, since the true profits can only be ascertained after the provision is made, whereas reserves are appropriations of profit, the assets by which they are represented being retained to form part of the capital employed in the business.

Provisions are usually shown in the Balance Sheet by way of deductions from the assets in respect of which they are made, whereas general reserves and reserve funds are shown as part of the proprietor's interest.

A Capital Reserve is one which is not regarded as available for distribution through the Profit and Loss Account. It may consist of such items as premiums on the issue of shares, profit on re-issue of forfeited shares, profit on sale of fixed assets, the surplus arising on revaluation and writing up of fixed assets, profits earned prior to incorporation of a company, etc.

§ 2. Provision for Bad Debts

When a debt is found to be irrecoverable, it should be written off as a loss by means of a journal entry debiting Bad Debts Account and crediting the account of the defaulting debtor. At the end of the accounting period the Bad Debts Account is closed by transfer to the Profit and Loss Account. Should a debt which has been written off as bad be subsequently recovered, in whole or in part, the debtor's personal account should be debited and Bad Debts Account credited, the cash received then being credited to the debtor's account. This is preferable to posting the amount recovered direct from the Cash Book to the credit of the Bad Debts Account without making any entry in the debtor's personal account, since it is desirable, for future reference, that this account should contain a full history of the occurrence.

After all debts which are known to be irrecoverable have been written off, there may still be some doubtful accounts for which it would be prudent to provide. A provision for bad or doubtful debts may be calculated either by reference to the amounts of the specific debts which are regarded as doubtful, or by way of a percentage on the total debts outstanding. In many businesses experience shows that the percentage of bad debts to outstanding debtors does not fluctuate widely from year to year and in such cases this method may, as a rule, quite safely be employed. Sometimes the percentage is calculated on turnover, but this method is not recommended, since the potential bad debts stand in direct relation to the outstanding debts and not to turnover.

When the actual bad debts are written off, they should be transferred to the debit of Bad Debts Account, and when the final accounts for the period are prepared, the necessary provision may be debited and carried down to the credit of this account, the balance being transferred to Profit and Loss Account.

Illustration (1)

The outstanding debtors of a business at 1st January, 19.., are £20,000, and at 31st December, 19.., £25,000. Provision is made for doubtful debts at 4% on the outstanding debtors. Bad debts written off during the year amount to £750. Show the Bad Debts Account for the year, and the amount to be written off to Profit and Loss Account.

BAD DEBTS ACCOUNT

19..		£	19..		£
Dec. 31	To Debts written off	750	Jan. 1	By Provision b/f. 4% on £20,000 ..	800
	Provision c/d. 4% on £25,000 ..	1,000	Dec. 31	„ Profit and Loss Account	950
		£1,750			£1,750
			19..		
			Jan. 1	By Provision b/d.	1,000

Alternatively, a separate account may be kept for the provision for doubtful debts, the balance of which is adjusted at the end of the accounting period to the amount of the provision it is desired to carry forward, by a transfer either to the Bad Debts Account or direct to Profit and Loss Account.

Illustration (2)

Assuming the facts as stated in the previous example:

BAD DEBTS ACCOUNT

		£			£
19.. Dec. 31	To Sundry Debtors (detailed)	750	19.. Dec. 31	By Profit and Loss Account	950
	„ Provision for Doubtful Debts Account: Increase in Provision	200			
		£950			£950

PROVISION FOR DOUBTFUL DEBTS ACCOUNT

		£			£
19.. Dec. 31	To Provision c/d., 4% on £25,000 ..	1,000	19.. Jan. 1	By Provision b/f. 4% on £20,000 ..	800
			Dec. 31	„ Bad Debts Account	200
		£1,000			£1,000
			19.. Jan. 1	By Provision b/d.	1,000

Note: If preferred, the increase in the provision can be transferred direct to Profit and Loss Account, in which the bad debts written off and the increase in the provision will be debited thus:

Bad Debts written off	£750	
Provision for Doubtful Debts – Increase ..	200	
		£950

The following illustration incorporates the recovery of debts previously written off as bad:

Illustration (3)

At 1st January, a company had a Provision for Doubtful Debts of £500, against specific debtors, made up of B., £120; C., £100; D., £60; K., £60; L., £5; M., £61; N., £94. During the year to 31st December, the following debts proved to be bad: A., £15; B., £240; C., £210; D., £60; E., £90; F., £180. Debts were recovered in respect of amounts written off as bad in previous years, *viz.*, G., £70; H., £110. Of the debts provided for at 1st January, the following were paid during the year: K., £34; L., £5; M., £50, and the balances of K.'s and M.'s Accounts, were written off. At 31st December, the following debts were deemed doubtful, and a provision was created against them: N., £47; P., £140; Q., £155; R., £10; S., £320. Show the Bad Debts Account and how the amounts would appear in the Profit and Loss Account.

BAD DEBTS ACCOUNT

19..		£	£	19..		£	£
Jan./Dec.	To Sundry Debtors, amounts written off as bad:			Jan. 1	By Balance, Provision b/f. ..		500
	A.	15		Jan./Dec.	„ Sundry Debtors— Bad debts recovered:		
	B.	240			G.	70	
	C.	210			H.	110	
	D.	60					180
	E.	90		Dec. 31	„ Profit and Loss Account:		
	F.	180			Bad Debts written off *less*		
	K.	26			recoveries	652	
	M.	11			Increase in Provision ..	172	
			832				824
Dec. 31	„ Balance, Provision c/d. ..						
	N.	47					
	P.	140					
	Q.	155					
	R.	10					
	S.	320					
			672				
			£1,504				£1,504
				19..			
				Jan. 1	By Balance, Provision b/d. ..		672

The provision for doubtful debts has the effect of reducing the estimated realisable amount of the book debts, and is therefore deducted, inset, from the amount of the asset 'Debtors' in the Balance Sheet.

§ 3. Provisions for Cash Discounts

Where cash discounts are allowed and received, the amounts of the debts and liabilities actually received and paid will be less than the amounts appearing in the books, but opinions differ as to whether provision should be made for discounts to be allowed on outstanding balances when preparing the final accounts. On the one hand, it may be contended that unless the discounts allowable and receivable on outstanding debtors and creditors are taken into account, the book debts and liabilities will be overstated in the Balance Sheet which will not, therefore, disclose the true position of affairs. The counter argument is that as cash discount is an allowance for payment within a specified time, it is analogous to interest on loans and should enter into the computation of profit for the period which enjoys, or is deprived of, the use of the money. The point is not of great importance, and so long as the same procedure is followed consistently, no objection can be taken whichever method is employed. No credit should, however, be taken for discount to be received from creditors unless provision is made for the discount to be allowed to debtors.

Where provision for discounts is made, it may either be carried down in the Discount Account or recorded in a Provision for Discounts Account, which should be operated in the same way as a Provision for Doubtful Debts Account. Care must be taken to calculate the amount of the provision for discounts allowable only on *good* debts, *i.e.*, on the total of the outstanding debts less the provision for doubtful debts (if any).

Where credit is taken for discounts to be received on outstanding liabilities the stock-on-hand should be valued for Balance Sheet purposes at the discounted and not the gross cost.

Where provision for discounts is being created for the first time, an adjustment must be made for the discounts allowable and receivable on the opening debtors and

creditors, which should be eliminated from the Discount Account, and shown separately in the Profit and Loss Appropriation Account.

In the Balance Sheet the provisions for discounts should be deducted, inset, from the trade creditors and debtors respectively.

§ 4. Outstanding Liabilities

It usually happens that at the date of balancing the accounts certain liabilities which have become due or are accruing have not been recorded in the books. These may include such items as rent or rates, charges for gas, water, electric light, telephone, or similar items consumed or incurred during the period, for which no account has yet been received.

All such items must be brought into account either by a journal entry debiting the nominal account concerned, and crediting an 'Outstanding Liabilities' or 'Sundry Creditors' Account, or by carrying down the outstandings in the nominal accounts themselves. The latter method is more usually adopted, and the following illustration shows how the accounts are affected.

Illustration

The books of a manufacturer are closed at 31st December, and the following debit balances appear in the Trial Balance:

Rent and Rates	£765
Gas, Electric Light and Water	£112

One quarter's rent, amounting to £145, is due but not yet paid. A demand note for local rates for the half-year ending 31st March following, amounting to £90, has been received but has not been paid. There are outstanding liabilities not yet brought into account in respect of gas, £16; water £9.

Show the accounts as they will appear when the books are closed off.

RENT AND RATES ACCOUNT

			£			£
19.. Dec. 31	To Expenses paid (detailed) ..		765	19.. Dec. 31	By Profit and Loss Account	955
	" Balance Outstanding c/d. ..					
	Rent	£145				
	Rates (1 Quarter) ..	45				
			190			
			£955			£955
				19.. Jan. 1	By Balance b/d.	190

GAS, ELECTRIC LIGHT AND WATER ACCOUNT

			£			£
19.. Dec. 31	To Expenses paid (detailed) ..		112	19.. Dec. 31	By Profit and Loss Account	137
	" Balance Outstanding c/d.:					
	Gas	£16				
	Water	9				
			25			
			£137			£137
				19.. Jan. 1	By Balance b/d.	25

It will be seen from the foregoing illustration that the charges to Profit and Loss Account are increased to the extent of the sums outstanding; and the balances brought down are, for the purpose of the Balance Sheet, treated as liabilities.

When the charge is paid during the succeeding period, it will be debited to the nominal account, but will be offset by the balance brought down, so that it is not included in the charge to Profit and Loss Account for that period.

The same principle can be applied to any nominal accounts; but, so far as purchases are concerned, it is better, where possible, to pass all the invoices through the purchases day book (where one is kept) during the period to which they relate.

Where the system of debiting the nominal accounts concerned and crediting a separate account is adopted, all the credits can be passed through an Outstanding Liabilities Account, which may be regarded as a Suspense Account for the purpose of adjusting the outstandings. In this case the items in the Suspense Account must, at the commencement of the succeeding period, be transferred back to the relevant nominal accounts, or care be taken that the payments in respect thereof are debited to the Suspense Account.

§ 5. Payments in Advance

It frequently happens that payments for expenses such as rent, rates, insurances, etc., made during a period, refer wholly or partly to a succeeding period. The treatment of such items is analogous to that of outstanding liabilities, and the following illustration shows the effect of their adjustment upon the accounts.

Illustration

The books of a manufacturer are closed at 31st December, and included in the Trial Balance is a debit balance of £260 for Rent and Rates Account.

The sum of £40 for local rates for the half-year ending 31st March following was paid on the 1st December.

Show the adjustment on the nominal account for the purpose of the Balance Sheet.

RENT AND RATES ACCOUNT

19 .		£	19 .		£
Dec. 31	To Expenses (detailed)	260	Dec. 31	By Balance c/d: One Quarter's Rates, paid in advance..	20
			"	" Profit and Loss Account ..	240
		£260			£260
19..					
Jan. 1	To Balance b/d.	20			

It will be seen from the foregoing illustration that the charge against profit for the current period is reduced by the amount carried forward to the succeeding period. This amount will appear in the Balance Sheet as an asset and will increase the charge to Profit and Loss Account in the succeeding period. Where there are several items of expenditure paid in advance, it is common for the total to be included in the Balance Sheet under a composite description such as: 'Prepayments' or 'Amounts paid in Advance'.

§ 6. Definition of Depreciation, and the considerations necessary to determine its rate

Depreciation is the measure of the exhaustion of the effective life of a fixed asset owing to use or obsolescence during a given period. It may be regarded as that part of the

cost of the asset which is not recoverable when the asset is finally put out of use. The object of providing for depreciation is to spread the expenditure incurred in acquiring the asset over its effective lifetime, and the amount of the provision made in respect of an accounting period is intended to represent the proportion of such expenditure which has expired during that period.

The term 'use' has been employed in the above definition of depreciation to cover not only the wear and tear, but also exhaustion of the contents of wasting assets such as mines and quarries, and the effluxion of time in the case of assets such as leases, for which there is a time limit of ownership.

Obsolescence occurs when it becomes beneficial to replace an asset before the end of its normal effective life by a new and improved type of asset or process which will perform the same or a similar service more efficiently and more economically. Obviously, it is difficult to provide for obsolescence, as it is an element which is incapable of being foreseen with accuracy; a new invention may arrive most unexpectedly.

Depreciation is sometimes divided broadly into two classes:

(*a*) Internal, and (*b*) External.

Internal depreciation is that arising from the operation of any cause natural to or inherent in the asset itself, *e.g.*, wear and tear in the case of plant and machinery.

External depreciation is that arising from the operation of forces apart from the asset itself, *e.g.*, obsolescence in the case of plant and machinery.

The term 'depreciation' must not be confused with 'fluctuation', which implies a temporary change in market value quite distinct from any depreciation which may occur.

In order to assess the rate of depreciation, consideration must be given to three factors: the cost of the asset, its effective life (by which is meant the period during which the asset will be of profitable service to the business) and its probable residual value when its effective life comes to an end. The last two factors are not capable of precise calculation and can only be determined by estimation.

In estimating the effective life, the various forces operating to cause depreciation must be carefully distinguished. It is usually possible to forecast the depreciation by use, such as wear and tear, with reasonable accuracy, given the necessary experience and knowledge of the business concerned; but the external forces such as obsolescence are so uncertain that in many cases they are ignored until the actual loss caused thereby has been ascertained. In making the estimation consideration must be given to the state of repair in which it is intended to maintain the asset, *e.g.*, some machines can have their lifetime considerably extended by the periodical renewal of certain components. The skill of the operatives is also a factor to be taken into account. The effective life has been defined as 'the period beyond which it does not pay either to keep the asset in use by repair, or to renew a part of it'.

§ 7. The Necessity of Providing for Depreciation

At the end of its effective life, the asset ceases to earn revenue, *i.e.*, the capital outlay has expired, and the asset will have to be replaced or a substitute found. Provision for depreciation is the setting aside out of the revenue of an accounting period the

estimated amount by which the capital invested in the asset has expired during that period. It is the provision made for the loss or expense incurred through using the asset for the purpose of earning profits, and should therefore be charged against those profits as they are earned.

If the whole of the profits were withdrawn without providing for depreciation, moneys would not be accumulated out of revenue during the life of the asset for the purpose of replacing it, and consequently when it becomes necessary to replace the asset new capital would have to be found for the purpose.

If depreciation is not provided for, the books will not contain a true record of revenue or capital. If the asset were hired instead of purchased, the hiring fee would be charged against the profits; having been purchased, the asset is, in effect, then hired by capital to revenue, and the true profit cannot be ascertained until an analogous charge for the use of the asset has been made. Moreover, unless provision is made for depreciation, the Balance Sheet will not present a true and fair view of the state of affairs, since the assets will be shown at an amount which is in excess of the true amount of the unexpired expenditure incurred on their acquisition.

It is outside the scope of the present work to discuss the question whether a limited company is under any legal obligation to provide for depreciation on its fixed and wasting assets. The matter is considered here from the point of view of business finance and accountancy. The contention is that depreciation, taking place as it does irrespective of the results of the business, should be recorded in the books in the same way as any other transaction, if those books are to show the true facts of the case.

Under the simplest methods of providing for depreciation, the amount of the provision is credited to the asset account and debited to a Depreciation Account, which, in due course, is transferred to the debit of Profit and Loss Account.

The effect of writing off depreciation in this way is illustrated in the following simple Balance Sheets:

A. is a sole trader, whose summarised Balance Sheet, before providing for depreciation, is as follows:

	£		£
Capital	11,000	Sundry Assets	7,500
Creditors	2,000	Machinery	6,000
Profit and Loss Account	3,000	Cash	2,500
	£16,000		£16,000

If A. were to withdraw the whole £3,000 profits he would have to realise £500 of the sundry assets, and if he consistently withdrew the whole of the profits for the remainder of the effective life of the machinery, his Balance Sheet on the expiry of that life (assuming other things unaltered), would be as follows:

	£		£
Capital	11,000	Sundry Assets	7,000
Creditors	2,000	Loss on Machinery	6,000
	£13,000		£13,000

In order to replace the machinery, therefore, fresh capital would have to be introduced.

Reverting to the first Balance Sheet, if A. provided for depreciation to the extent of £800, the effect on that Balance Sheet would be to reduce the profits available for withdrawal to £2,200, and after withdrawing these, £800 would be retained in the business in the form of cash and/or sundry assets. At the end of the effective life (*cf.* second Balance Sheet) instead of there being a loss, there would be £6,000 of cash and/or other assets available for replacing the machinery, the capital outlay having been made good, as it expired, out of revenue.

Provision for depreciation is normally based upon the original capital outlay, plus the cost of all major renewals which increase the revenue earning capacity of the asset (but not those which merely maintain it), less the estimated scrap value.

Depreciation for the accounting period during which an asset is acquired should strictly be calculated on a time basis from the date of acquisition to the date of the balance sheet. In cases where a number of additions to fixed assets are made throughout an accounting year, it is often considered desirable to take the average date thereof for the purpose of computing depreciation. In some businesses, however, it is customary to charge a full year's depreciation on the assets in use at the end of the accounting period, ignoring fractions of years.

The treatment of obsolescence depends upon the facts. It may be shown, from past experience, that important developments or changes in particular types of assets can be expected at fairly regular intervals. If so, this factor should be taken into consideration in estimating the effective life. In most cases, however, obsolescence occurs more or less unexpectedly, and should be provided for as and when it arises. Frequently the loss through obsolescence is of such a large amount that it cannot be met out of the revenue of any one period, and must be provided for either out of capital or by being written off gradually over a period of years as an abnormal loss.

Another question to which increasing emphasis has been given in recent years is the impact of inflation on the replacement cost of assets, and whether in times of rising prices, it is desirable and proper to base the provision for depreciation, not upon the actual historical cost of assets, as has been the practice in periods of relative price stability, but upon estimated expenditure that will be incurred in replacing the assets in respect of which the provision is made.

The provision for replacement of assets and the measurement of profits are complementary problems, and the combined effect of the steep rise in price levels and heavy taxation have caused doubt to be thrown on the validity of the methods of ascertaining profit hitherto generally followed. Broadly, it is contended that the capital employed in a business is to be measured, not by the amount of money contributed by the proprietors, including profits left in the business, but by the capacity of that money to purchase goods and equipment. Accordingly it is maintained that the true profit can only be ascertained after providing out of revenue the funds necessary to replace stocks and fixed assets at the sums which will have to be expended for that purpose. It is pointed out that where the revenue itself is inflated by the rise in price levels, the charges against revenue should be measured by a similar yardstick if true profits are to be ascertained.

The suggestion has been made, and strongly advocated in some quarters, that the

values at which fixed assets appear in the Balance Sheet should be written up to the estimated present cost of replacing them by identical assets in a comparable condition, and that thereafter depreciation charged against profits should be calculated on the written-up values. Certain important British companies, and many continental ones, have adopted this practice in recent years.

The Council of the Institute of Chartered Accountants in England and Wales examined this matter in all its aspects and published a memorandum, wherein, whilst recognising the urgent need for the maintenance of industrial efficiency by the making of adequate provision for the replacement of lost capital, they indicated that they saw no need to modify the advice previously given that the charge for depreciation should be based on historical cost, and that any amounts set aside to finance enhanced costs should be treated as transfers to reserve. The Council considered that the proposal to base the charge for depreciation on other than historical cost is at variance with the accountancy practice hitherto generally followed, of treating as charges to revenue the actual monetary cost of stocks consumed and capital expired, and would lead to inconsistency and confusion. It was pointed out that the logical application of the method advocated by those who desire a change would require them not only to make charges against revenue on new bases in respect of stocks and fixed assets, but also to provide for the diminished purchasing power of cash and other liquid assets to be used in the business. It would be illogical, in ascertaining profit, to treat as a necessary charge the cost of maintaining the purchasing power of money provided by the issue of fixed preference or loan capital, whilst ignoring the corresponding reduction in the obligation, expressed in terms of purchasing power, to the holders of that capital. If the new conception were adopted, the holders of preference shares might be deprived of dividends without acquiring any capital benefit.

The Council recommended directors of companies to consider, in relation to the circumstances of their companies, the effects of the rise in price levels and the relative merits of (*a*) relying upon the company's ability to raise new capital as and when it may be required for the purpose of meeting enhanced replacement costs, and (*b*) the desirability of setting aside and accumulating out of profits such sums for this purpose as may be practicable. This consideration may be a matter of major importance in determining the amount of profits which, from the standpoint of financial prudence, should be regarded as available for dividend.

The Council further recommended that in order to emphasise that, as a matter of prudence, the amount set aside is, for the time being, regarded as not available for distribution, it should normally be treated as a specific capital reserve for increased cost of replacement of assets. For Balance Sheet purposes, fixed assets should not, as a general rule, be written up on the basis of estimated replacement costs, especially in the absence of a measure of stability in the price level.

The Council of the Association of Certified and Corporate Accountants, on the other hand, comes down on the side of the advocates of the replacement value basis of provision for depreciation. They recommend that the charge for depreciation be divided into two parts:

The fixed instalment system is recommended by the Council of the Institute of Chartered Accountants as the most suitable in the majority of cases. The full text of the recommendation will be found on pages 64 and 65.

In view of the provision in the Companies Act, 1948, which requires the cost of fixed assets and the aggregate amount of the provision made for depreciation thereon to be disclosed in the Balance Sheet, the practice is being increasingly adopted of retaining the assets in the accounts at original cost, and crediting the provision for depreciation to a separate account, instead of to the asset accounts. When an asset is sold or discarded, the original cost is transferred from the asset account, and the total provision made for depreciation thereon from the Provision for Depreciation Account, to a Fixed Assets Disposals Account, the balance of which will represent the written down value of the asset at the date on which it is sold or discarded. The proceeds of sale (if any) will be credited to this account, which will then disclose the profit or loss arising from the transaction.

By this method, the balances on the fixed assets accounts will always represent the cost of the fixed assets actually in use, and the balances of the Provision for Depreciation Accounts the aggregate amount of depreciation thereon to date.

Illustration (2)

B & Co. commenced manufacturing on 1st January, 1956. They purchased plant as follows:

		£
1956		
Jan. 1	.. .. ..	4,000
July 1	.. .. ..	2,000
1958		
April 1	.. .. ..	3,000

Depreciation is provided for on the 'straight line' method at the rate of 10 per cent. per annum from the date of purchase, a separate account being opened for the provision made.

On 30th June, 1957, the machine which had been purchased on 1st July, 1956, was sold for £1,200.

Write up the ledger accounts involved.

PLANT ACCOUNT

		£			£
1956			1956		
Jan. 1	To Machine	4,000	Dec. 31	By Balance c/d.	6,000
July 1	" "	2,000			
		£6,000			£6,000
1957			1957		
Jan. 1	To Balance b/d.	6,000	June 30	By Plant Disposal Account – Plant Sold ..	2,000
			Dec. 31	" Balance c/d.	4,000
		£6,000			£6,000
1958			1958		
Jan. 1	To Balance b/d.	4,000	Dec. 31	By Balance c/d.	7,000
Apr. 1	" Machine	3,000			
		£7,000			£7,000
1959					
Jan. 1	To Balance b/d.	7,000			

PROVISION FOR DEPRECIATION ON PLANT ACCOUNT

		£			£	£
1956			1956			
Dec. 31	To Balance c/d.	500	Dec. 31	By Profit and Loss Account:		
				12 months on £4,000 ..	400	
				6 " £2,000 ..	100	
						500
		£500				£500
1957			1957			
June 30	To Plant Disposal Account .. .. (on £2,000 for 1 year)	200	Jan. 1	By Balance b/d.		500
Dec. 31	" Balance c/d.	800	Dec. 31	" Profit and Loss Account:		
				12 months on £4,000 ..	400	
				6 " £2,000 ..	100	
						500
		£1,000				£1,000
1958			1958			
Dec. 31	To Balance c/d.	1,425	Jan. 1	By Balance b/d		800
			Dec. 31	" Profit and Loss Account:		
				12 months on £4,000 ..	400	
				9 " £3,000 ..	225	
						625
		£1,425				£1,425
			1959			
			Jan. 1	By Balance b/d.		1,425

PLANT DISPOSAL ACCOUNT

		£			£
1957			1957		
June 30	To Plant Account:		June 30	By Provision for Depreciation Account:	
	Cost of Plant sold	2,000		Depreciation for 1 year on £2,000 ..	200
				" Cash – Sale	1,200
				" Profit and Loss Account	600
		£2,000			£2,000

Note. The Plant will appear in the Balance Sheet at 31st December, 1958, as:

Plant at cost	£7,000
Less Provision for Depreciation	£1,425
	£5,575

(b) The Reducing Instalment System, or Diminishing Balance Method

Under this system, a fixed rate per cent. on the *diminishing* value of the asset is written off each year, so as to reduce the asset to break-up value at the end of its life, repairs and small renewals being charged to revenue. This method is commonly used for plant, fixtures, furniture, etc. Among the advantages claimed for this method are the following:

(1) The early years are charged with the largest amounts for depreciation, thus reducing the asset in the same ratio as its loss in value for resale accrues, it being recognised that normally a new asset loses its saleable value most rapidly when first put into use. (This introduces into the question a factor which strictly does not affect depreciation, *viz.*, fluctuation in value.)

(2) The asset is never completely written off, so that some charge is made to revenue in every year, whereas under the straight line method there will be no charge to revenue in years after the expiration of the basic period adopted for computing the rate of depreciation, even though the asset remains in use.

(3) The asset loses efficiency as it gets older and the charge for depreciation should decrease accordingly. (This is not true of all assets.)

(4) It is very simple in operation, and the total charge to revenue in respect of depreciation and repairs is more equal each year than under method (*a*), since, while the charge for depreciation is heavy in the early years, that for repairs is lighter, the latter increasing as the former decreases; whereas under (*a*) the charge for depreciation is constant, while repairs will tend to increase.

This argument may be sound when applied to an individual asset. In practice, however, when there is a large number of assets, which are renewed at intervals, the total cost of repairs, taking old assets with new, and the total depreciation charge, will not fluctuate to any great extent from year to year. When a single asset is considered, however, the objection to the fixed instalment method can be overcome by charging to revenue an equal sum each year for repairs and crediting such sum to a Provision for Repairs Account. As repairs are effected the cost thereof is charged to the Provision for Repairs Account and, if the annual sum has been calculated correctly, the provision will be exhausted at the expiration of the asset's life (*see* § 9 *post*).

It is desirable, however, under the reducing instalment system, to re-value the asset from time to time, to ensure the effectiveness of the rate utilised, and it is inadvisable to apply this system to assets whose life is so short as to involve an unduly heavy charge in the earlier years.

Among the disadvantages of this method are the danger that too low a percentage may be adopted, with a result that over the life of the asset full depreciation will not be provided; and, owing to its simplicity of operation, assets are grouped in such a way that individual assets are difficult to identify and the residue of each may be left in the asset account even after the asset has been scrapped. The latter disadvantage can readily be overcome, however, by the maintenance of adequate plant registers. In the later years, the interest earned on the assets retained as a result of writing off the depreciation frequently exceeds the actual charge for those years.

Illustration

Balance of Plant Account at 1st January, 1957, £1,726.

Additions during 1957, £321, and 1958, £57.

Depreciation at 10% per annum on the Reducing Instalment System. Calculate to nearest £.

PLANT ACCOUNT

		£			£
1957			**1957**		
Jan. 1	**To Balance b/f.**	1,726	**Dec. 31**	**By Depn. 10% on £1,726**	173
Dec. 31	**„ Additions**	321		**„ Balance c/d.**	1,874
		£2,047			**£2,047**
1958			**1958**		
Jan. 1	**To Balance b/d.**	1,874	**Dec. 31**	**By Depn. 10% on £1,874**	187
Dec. 31	**„ Additions**	57		**„ Balance c/d.**	1,744
		£1,931			**£1,931**
1959					
Jan. 1	**To Balance b/d.**	1,744			

On occasions it may be preferable to adopt the reducing instalment system in the early years, and then to change over to the fixed instalment system to ensure that the asset is completely depreciated.

As already explained in connection with the fixed instalment system, the asset may be left in the books at cost, the depreciation being credited to a Provision for Depreciation Account.

(c) The Annuity System

By this method the capital locked up in the asset is regarded as earning a fixed rate of interest, and such constant annual amount is written off as, after debiting the asset account with the fixed rate per cent. upon the diminishing value, will reduce it to nil or scrap value at the end of its life.

This is the most scientific system when investment is not desired outside the business, but may be criticised from the viewpoint that it introduces an uncertain element, *i.e.*, the rate of interest, which is bound to be arbitrarily arrived at, and also that it is not sufficiently conservative in the early years, so that if obsolescence supervenes the true depreciation will not have been provided; but the latter objection can be met by shortening the estimated life on which the calculations are based. The annuity system is specially applicable to cases such as long leases, where no additions are made to the asset during its life. It is not generally used for plant, since, when additions are made from time to time, these would at once necessitate further calculations.

The interest debited to the asset account is credited to revenue, and this item diminishes each year with the value of the asset, although the amount written off as depreciation remains constant. There is, therefore, an increasing net charge to revenue in respect of the asset. This increasing charge, however, is more apparent than real, as the assets retained as a result of writing off depreciation will presumably earn profits, which will offset the diminution of interest charged to the asset, as can be seen from the table following the next illustration.

Illustration

Lease costing £600 for a term of five years. Depreciation by the Annuity Method at 5% per annum.

LEASE ACCOUNT

		£ s. d.			£ s. d.
Year 1			Year 1		
Jan. 1	To Cash	600 0 0	Dec. 31	By Depreciation Account ..	138 11 8
Dec. 31	„ Interest Account. 5% ..	30 0 0		„ Balance c/d.	491 8 4
		£630 0 0			£630 0 0
Year 2			Year 2		
Jan. 1	To Balance b/d.	491 8 4	Dec. 31	By Depreciation Account ..	138 11 8
Dec. 31	„ Interest Acount	24 11 5		„ Balance c/d.	377 8 1
		£515 19 9			£515 19 9
Year 3			Year 3		
Jan. 1	To Balance b/d.	377 8 1	Dec. 31	By Depreciation Account ..	138 11 8
Dec. 31	„ Interest Account	18 17 5		„ Balance c/d. ..	257 13 10
		£396 5 6			£396 5 6
Year 4			Year 4		
Jan. 1	To Balance b/d.	257 13 10	Dec. 31	By Depreciation Account ..	138 11 8
Dec. 31	„ Interest Account	12 17 8		„ Balance c/d.	131 19 10
		£270 11 6			£270 11 6

LEASE ACCOUNT (*continued*)

		£ s. d.			£ s. d.
Year 5			Year 5		
Jan. 1	To Balance b/d	131 19 10	Dec. 31	By Depreciation Account ..	138 11 10
Dec. 31	„ Interest Account	6 12 0			
		£138 11 10			£138 11 10

Note. The annual amount of depreciation under this system is calculated from actuarial tables compiled for the purpose. There will usually be differences arising from fractions of a penny which will be adjusted in the last year.

DEPRECIATION AND INTEREST ACCOUNT

		£ s. d.			£ s. d.
Year 1			Year 1		
Dec. 31	To Lease Account – Depreciation	138 11 8	Dec. 31	By Lease Account – Interest ..	30 0 0
				„ Profit and Loss Account ..	108 11 8
		£138 11 8			£138 11 8
Year 2			Year 2		
Dec. 31	To Lease Account – Depreciation	138 11 8	Dec. 31	By Lease Account – Interest .	24 11 5
				„ Profit and Loss Account .	114 0 3
		£138 11 8			£138 11 8
Year 3			Year 3		
Dec. 31	To Lease Account – Depreciation	138 11 8	Dec. 31	By Lease Account Interest ..	18 17 5
				„ Profit and Loss Account .	119 14 3
		£138 11 8			£138 11 8
Year 4			Year 4		
Dec. 31	To Lease Account – Depreciation	138 11 8	Dec. 31	By Lease Account Interest .	12 17 8
				„ Profit and Loss Account ..	125 14 0
		£138 11 8			£138 11 8
Year 5			Year 5		
Dec. 31	To Lease Account – Depreciation	138 11 10	Dec. 31	By Lease Account – Interest	6 12 0
				„ Profit and Loss Account ..	131 19 10
		£138 11 10			£138 11 10

Note. In practice this account might not be used, depreciation and interest being debited and credited respectively to their separate accounts, but it is shown here in order to illustrate the increasing charge each year to Profit and Loss Account.

It will be seen from the above example that the profits available for distribution are decreased in each year to the extent of the net charge to Profit and Loss Account, and it will be evident that, as a result of this charge, there are retained in the business as working capital assets that might otherwise have been distributed as dividend. These assets will themselves earn revenue, and if it is assumed that the profits thereon are only equal to 5% per annum, the equality of the real charge to Profit and Loss Account in each year will be seen from the following table.

Year to 31st Dec.	Charge to Profit and Loss Account as above	Amount of interest deemed to be earned by accumulations of assets retained in business as a result of the charge for depreciation.		Real net charge to Profit and Loss Account.
		5% on	Amount	
	£ s. d.	£ s. d.	£ s. d.	£ s. d.
Year 1	108 11 8	—	—	108 11 8
Year 2	114 0 3	108 11 8	5 8 7	108 11 8
Year 3	119 14 3	222 11 11	11 2 7	108 11 8
Year 4	125 14 0	342 6 2	17 2 4	108 11 8
Year 5	131 19 10	468 0 2	23 8 0	108 11 10

(d) The Depreciation Fund, or Sinking Fund System

Under this system, a constant amount is debited to the Profit and Loss Account each year, and credited to a Depreciation Fund Account, and an equivalent amount of cash is invested outside the business in gilt-edged securities, and allowed to accumulate at compound interest so as to produce the required amount at the completion of a given number of years.

This system is adopted where it is necessary to replace the asset at the end of its life, and to provide moneys *outside the business* for such purpose. This will avoid any disturbance of the financial position, such as might occur if large sums had to be withdrawn from the business at any particular moment, since money left in the business is liable to be employed as working capital.

Sometimes, instead of being invested outside the business, the sums set aside are used in the business. In that case, a charge for interest on the accumulated fund should be made, by debiting Profit and Loss Account and crediting the Fund Account. This provides for the depreciation, but does not ensure that the cash will be available, when required, to replace the asset, as the fund may be represented by business assets which cannot readily be realised. *Primâ facie*, this method has the disadvantage that the gross charge to Profit and Loss Account increases from year to year, but, as already explained, the assets representing the fund will be earning income, which goes to increase the profits available. Moreover, the use of the term 'depreciation fund' in such a case would be misleading, as the designation 'fund' should only be applied where the amount is represented by a fund of readily realisable and earmarked investments.

The sum to be set aside each year is ascertained by reference to interest tables, or can be computed by ordinary arithmetical calculation, *e.g.*, to find what annual sum must be set aside at the end of each year and invested at 3% compound interest to provide £2,091 16s. 3d. at the end of four years, the following calculation may be made:

If the sum set aside at the end of the first year were	£100·0000
Interest for second year @ 3% thereon	3·0000
	103·0000
Sum set aside at end of second year	100·0000
	203·0000
Interest for third year @ 3% thereon	6·0900
	209·0900
Sum set aside at end of third year	100·0000
	309·0900
Interest for fourth year @ 3% thereon	9·2727
	318·3627
Sum set aside at end of fourth year	100·0000
Amount at end of four years	£418·3627

If £418·3627 would be produced by the annual investment of £100,

then £2,091·8125 would be produced by the annual investment of $£\frac{2091{\cdot}8125 \times 100}{418{\cdot}3627} = £500$

Illustration

Lease costing £2,091 16s. 3d. for term of four years. Depreciation by the Depreciation Fund System at 3% per annum. Replaced at expiration by lease costing £2,000.

DEPRECIATION FUND ACCOUNT

		£ s. d.			£ s. d.
Year 2 Dec. 31	To Balance c/d.	1,015 0 0	Year 1 Dec. 31	By Profit and Loss Account ..	500 0 0
			Year 2 Dec. 31	" Cash: Interest	15 0 0
			"	" Profit and Loss Account ..	500 0 0
		£1,015 0 0			£1,015 0 0
Year 3 Dec. 31	To Balance c/d.	1,545 9 0	Year 3 Jan. 1	By Balance b/d.	1,015 0 0
			Dec. 31	" Cash: Interest	30 9 0
			"	" Profit and Loss Account ..	500 0 0
		£1,545 9 0			£1,545 9 0
Year 4 Dec. 31	To Lease Account	2,091 16 3	Year 4 Jan. 1	By Balance b/d.	1,545 9 0
			Dec. 31	" Cash: Interest	46 7 3
			"	" Profit and Loss Account ..	500 0 0
		£2,091 16 3			£2,091 16 3

INVESTMENT ACCOUNT

		£ s. d.			£ s. d.
Year 1 Dec. 31	To Cash	500 0 0	Year 2 Dec. 31	By Balance c/d.	1,015 0 0
Year 2 Dec. 31	" "	515 0 0			
		£1,015 0 0			£1,015 0 0
Year 3 Jan. 1	To Balance b/d.	1,015 0 0	Year 3 Dec. 31	By Balance c/d. ..	1,545 9 0
Dec. 31	" Cash	530 9 0			
		£1,545 9 0			£1,545 9 0
Year 4 Jan. 1	To Balance b/d.	1,545 9 0	Year 4 Dec. 31	By Cash	1,545 9 0
		£1,545 9 0			£1,545 9 0

LEASE ACCOUNT

		£ s. d.			£ s. d.
Year 1 Jan. 1	To Cash	2,091 16 3	Year 4 Dec. 31	By Depreciation Fund	2,091 16 3
		£2,091 16 3			£2,091 16 3

NEW LEASE ACCOUNT

		£ s. d
	To Cash	2,000 0 0

Notes to Illustration

(1) For the sake of simplicity the investments have been valued at par, and interest has been brought in yearly, without deduction of income tax, and invested as received.

(2) The interest received in and the allocation from profit at the end of the fourth year, amounting in all to £546 7s. 3d. would not be invested, but, with the proceeds of £1,545 9s. 0d. from the sale of the investment, would make up the balance on the Depreciation Fund Account of £2,091 16s. 3d.

(3) In many cases instructions are given to the bankers to collect the interest and to reinvest it in the principal stock as and when received, in which cases the dividends are never actually received, a book entry debiting the Investment Account and crediting the Depreciation Fund Account being made to record the transaction.

(4) In practice the investment will never realise exactly its book value owing to market fluctuations, brokers' commission, etc., which have, however, in this case been ignored.

(5) The Depreciation Fund Account is finally disposed of by transferring the balance to the Lease Account, thus closing both accounts. This illustrates the fact that the provision for a depreciation fund is a charge against profits, and not an appropriation thereof.

(6) Various terms are utilised in place of the phrase Depreciation Fund, *e.g.*, Redemption Fund, Amortisation Fund, Sinking Fund, etc.

Where the cost of replacement is estimated to exceed the cost of the original asset, and it is not desired to introduce new capital to meet such excess, but it is the intention to provide it out of profits, the fund must be computed at such amount as is necessary for the acquisition. As already indicated, the excess of such provision over the true depreciation charge should preferably be regarded as an *appropriation* of profits, not a charge against them.

(e) The Depreciation Fund with Endowment Policy System

In this case (which is merely another method of applying the depreciation fund system), instead of buying securities, an endowment policy is taken out for the life of the asset, so as to produce the amount required at the end of the particular period.

The charge is made to Profit and Loss Account in the same way as under the investment system, but the cash taken out of the business, instead of being invested in gilt-edged securities, is paid over by way of premium to an insurance company.

This method is becoming increasingly popular now that the insurance companies have found it possible to give such favourable terms, for although the interest is lower than could be obtained by investing in gilt-edged securities, there is no risk of loss on realisation as there is in an outside investment, provided a sound insurance company is chosen.

Some authorities consider that it is advisable for the Policy Account to be adjusted at the end of each year to the surrender value of the policy. In that case, when the policy matures, a greater sum will be received than that shown in the books to the debit of the Policy Account. This profit will be debited to the Policy Account and credited to the Depreciation Fund Account.

Other authorities take the view that, since the policy is for a fixed term, and there is no intention of surrendering it, there is no need to write it down to surrender value, but that it can be maintained at cost plus accrued interest, there being the equivalent Fund Account to correspond with it. Both viewpoints have a good deal to be said for them. The surrender value method, of course, is the more conservative, and maintains the policy in the Balance Sheet at its realisable value. This method is here illustrated.

Illustration

Lease costing £10,000 for a term of 50 years. Annual Premium on Endowment Policy is, say, £100. The surrender value of the policy is the amount of the premiums paid, excluding the first, plus 3 per cent compound interest.

DEPRECIATION FUND ACCOUNT

Date		£ s. d.	Date		£ s. d.
1st year Dec. 31	To Endowment Policy Account to adjust to surrender value ..	100 0 0	1st year Dec. 31	By Profit and Loss Account ..	100 0 0
2nd year Dec. 31	To Balance c/d.	103 0 0	2nd year Dec. 31	By Profit and Loss Account ..	100 0 0
				„ Endowment Policy Account: Adjustment to surrender value	3 0 0
		£103 0 0			£103 0 0
3rd year Dec. 31	To Balance c/d. . ..	209 1 9	3rd year Jan. 1	By Balance b/d.	103 0 0
			Dec. 31	„ Profit and Loss Account ..	100 0 0
				„ Endowment Policy Account: Adjustment to surrender value	6 1 9
		£209 1 9			£209 1 9
			4th year Jan. 1	By Balance b/d.	209 1 9

ENDOWMENT POLICY ACCOUNT

Date		£ s. d.	Date		£ s. d.
1st year Jan. 1	To Cash	100 0 0	1st year Dec. 31	By Depreciation Fund Account	100 0 0
2nd year Jan. 1	To Cash	100 0 0	2nd year Dec. 31	By Balance c/d. ..	103 0 0
Dec. 31	„ Depreciation Fund Account: Interest at 3% on £100 to adjust to surrender value ..	3 0 0			
		£103 0 0			£103 0 0
3rd year Jan. 1	To Balance b/d.	103 0 0	3rd year Dec. 31	By Balance c/d. ..	209
„	„ Cash	100 0 0			
Dec. 31	„ Depreciation Fund Account: Interest at 3% on £103 to adjust to surrender value ..	6 1 9			
		£209 1 9			£209 1 9
4th year Jan. 1	To Balance b/d.	209 1 9			

Notes to Illustration

(*a*) Although the premiums are paid on 1st January of each year, the transfers from Profit and Loss Account to Depreciation Fund Account would be made at the end of the year, when the accounts are closed.

(*b*) Since the surrender value of the policy is the amount of the premiums paid, excluding the first premium, plus interest, the surrender value at the end of the first year is nil. The whole amount standing to the debit of the Policy Account is therefore written off against the Depreciation Fund Account, and thereby against profit. In subsequent years the balance on the Policy Account is raised to surrender value by debiting the account with 3 per cent on the existing balance, the Depreciation Fund Account being credited.

(*c*) When the policy matures, the Endowment Policy Account will be credited and cash debited, any balance remaining on the Policy Account being transferred to the Depreciation Fund Account.

(f) Revaluation

It is advisable to resort to this method of ascertaining the amount of depreciation to be written off in the case of loose tools, plant which rapidly depreciates, live stock, patents, copyrights and similar assets. Should the revaluation disclose an appreciation brought about by additions from revenue, as in the case of loose tools and plant in an engineering business (the cost of which, in the shape of materials and wages, has been charged to the Manufacturing or Trading Account), such appreciation should be carried to the credit of that Account. In some cases, the depreciation or appreciation of assets dealt with on a revaluation basis is automatically brought into the Profit and Loss

Account by transferring the opening and closing values of the assets to that account in exactly the same way as is done with stock-in-trade.

Where the appreciation has not been brought about by additions from revenue, it will be of a capital nature, and if taken into consideration at all should be placed to the credit of a special reserve account.

(g) Depletion Unit System

In the case of wasting assets, such as mines and quarries, it is a matter of policy whether or not to make provision for depreciation. If the concern has been floated to work the asset, and to terminate when the asset is exhausted, the proprietors must regard each dividend received by them as being in part a return of their invested capital, and they must make personal provision thereout to replace that capital.

If, however, the concern is floated on the basis of working each asset in succession, acquiring a new asset as each old one is worked out, depreciation should be provided for on the depletion unit basis, such a sum being set aside out of profits each year as represents the expired capital outlay, on the basis of the produce extracted compared with the estimated total contents of the mine, etc.

Illustration

A plot of freehold land is acquired at a cost of £1,000 for quarrying. The estimated output of the quarry over its lifetime is 40,000 tons.

For each ton won the sum of 6d. must be written off the book value of the land, *i.e.*, if the tonnage won in a year is 2,000, the sum of £50 should be written off as depreciation.

(h) Machine Hour System

Where it is possible to keep records of the actual running hours of each machine, the 'machine hour' plan can be employed. Under this system, it is necessary to estimate the total effective working hours during the whole life of the machine, and to divide this total into the cost of the machine, less its scrap value, thus giving an hourly rate of depreciation. Depreciation is then written off at the hourly rate in respect of the number of hours the machine has been engaged during the period.

This system burdens each period with the exact amount of depreciation appropriate to its use of the machine, and can only usefully be employed in the case of large machines. Due consideration must be given to the fact that some depreciation must normally take place even when a machine is not in use.

The labour involved in the maintenance of records renders this system more expedient where a costing system is in operation.

(i) Sundry Systems

In some trades, machines are hired on the basis of a royalty payable according to the metered use of the machines, *e.g.*, per 10,000 revolutions. Depreciation can be written off on a similar basis.

In certain cases of small machines, with very short lives, the original expenditure

If the renewal is of the whole asset, the book value of the original asset will (if the rate of depreciation provided has been sufficient) have been reduced to nil or break-up value by the time the expenditure on renewal becomes necessary. This fact determines whether the expenditure on renewal can justifiably be charged to capital. If there remains any book value over and above the break-up value attaching to the asset to be replaced, only such proportion of the cost of replacement as will increase the book value of the asset to the current cost should be capitalised. The balance, which represents accumulated depreciation unprovided for in the past, should be charged to revenue.

It is important to consider whether it is necessary to provide for future expenditure on repairs during the early years of the life of an asset, when, although the current expenditure is comparatively light, it is known that the expenditure at a subsequent date will be considerable. Where large sums are involved, the best method is to estimate the total expenditure on repairs during the life of the asset, and to average it over that period. This may be done by raising a Provision for Maintenance Account, to which a credit is made each year from Profit and Loss Account of an amount equal to the average charge so computed. The actual expenditure, as and when it is incurred, will be debited to this account, the balance of which will be carried forward in the Balance Sheet as a reserve.

It may happen that this account will become temporarily in debit owing to excessive expenditure in any one period. If this excess is likely to be recouped during subsequent periods, it can be carried forward, but care should be taken to see that the average annual charge is sufficient for this purpose. If not recoupable, it must be written off at once, or spread over the remainder of the life of the asset by increasing proportionately the annual charge to revenue.

Dilapidations arising under a lease afford an illustration of expenditure on repairs which accrues at some subsequent period, but for which it is nevertheless advisable to provide during the life of the asset. The most convenient method of doing this is to estimate the charge for dilapidations, and add the amount thereof to the cost of the lease, for the purpose of calculating the amount of depreciation which should be written off each year, thus spreading the cost of the dilapidations over the whole period.

Illustration

A lease was acquired for 20 years, the tenant being liable for all repairs. A premium of £2,000 was paid, and it was estimated that repairs over the 20 years would amount to £1,000. The actual repairs in the first, second and third years were respectively £10, £30 and £25. Write up the Provision for Maintenance Account, bringing down the balance at the beginning of the fourth year.

PROVISION FOR MAINTENANCE ACCOUNT

		£			£
1st year	To Repairs	10	1st year	By Profit and Loss Account	
"	" Balance c/d.	40		Annual Charge	50
		£50			£50
2nd year	To Repairs	30	2nd year	By Balance b/d.	40
"	" Balance c/d.	60	"	" Profit and Loss Account	50
		£90			£90

PROVISION FOR MAINTENANCE ACCOUNT (*continued*)

		£			£
3rd year	To Repairs ..	25	3rd year	By Balance b/d. ..	60
	„ Balance c/d.	85	..	„ Profit and Loss Account	50
		£110			£110
			4th year	By Balance b/d.	85

If the repairs estimate proves to be exact there will be no balance at the end of the 20 years, but usually there would be some balance to be transferred to Profit and Loss Account. Depreciation would be provided for as usual.

§ 10. The Operation of Sinking Funds for the Repayment of Loans

A sinking fund for the redemption of a loan is created in a manner similar to the depreciation fund for the replacement of an asset described in § 8 (*d*), except that the annual provision is an appropriation of, and not a charge against profits. An equal amount is debited to the Profit and Loss Account each year, and credited to Sinking Fund Account, and an equivalent sum is invested outside the business in gilt-edged securities, and allowed to accumulate at compound interest, so as to produce the amount required to repay the loan at its due date.

Ultimately, the investments of the fund will be realised and the loan repaid, after which the credit balance remaining on the Sinking Fund Account should be transferred to Reserve Account, since the particular purpose for which the profits were appropriated has ceased to exist, and whereas the profits were formerly represented by specific investments, they are now represented by general assets of the business which have been acquired out of profits. This emphasises the fact that the amount set aside to a sinking fund for the repayment of a liability is an appropriation of profit, whereas the amount set aside to a depreciation fund for the purpose of replacing an asset, is a charge against profits (except, of course, to the extent that it may exceed the original capital outlay on the asset being depreciated). In the case of a sinking fund for the repayment of a loan, the net assets are *increased* by the amount of the fund; a depreciation fund merely *maintains* the net assets at their original book value.

The amounts allocated to a sinking fund are debited to Profit and Loss Account so that moneys may be accumulated and set aside *out of profits* to repay the liability, without having to provide additional capital moneys for that purpose. It would, of course, be possible to accumulate funds outside the business for the repayment of a liability simply by making annual investments of cash without debiting the Profit and Loss Account at all, but if this were done the balance of the Profit and Loss Account would exceed the amount of profits which are available for distribution, because the liquid resources of the business would have been reduced by the amounts invested.

The calculation of the annual amount to be invested is made in the same way as for a depreciation fund, already explained in § 8 (*d*) above.

Illustration (1)

On the 1st January, 19.., a loan to the extent of £500 was raised, repayable at par at the

end of five years, and it was resolved that a sinking fund should be formed to provide for its redemption.

Show the ledger accounts for the five years, assuming that the interest received on the investments representing the sinking fund was at the rate of 5 per cent. on the cost, that Income Tax was ignored, and that the interest was received yearly, and immediately invested.

Note. ·180975 of £1 invested at the end of each year, at 5 per cent. compound interest will produce £1 at the end of five years.

SINKING FUND ACCOUNT

		£ s. d.			£ s. d.
1st year Dec. 31	To Balance c/d.	90 9 9	1st year Dec. 31	By P. & L. Account	90 9 9
2nd year Dec. 31	To Balance c/d.	185 10 0	2nd year Jan. 1	By Balance b/d.	90 9 9
			Dec. 31	" P. & L. Account	90 9 9
				" Cash (Interest)	4 10 6
		£185 10 0			£185 10 0
3rd year Dec. 31	To Balance c/d.	285 5 3	3rd year Jan. 1	By Balance b/d.	185 10 0
			Dec. 31	" P. & L. Account	90 9 9
				" Cash (Interest)	9 5 6
		£285 5 3			£285 5 3
4th year Dec. 31	To Balance c/d.	390 0 3	4th year Jan. 1	By Balance b/d.	285 5 3
			Dec. 31	" P. & L. Account	90 9 9
				" Cash (Interest)	14 5 3
		£390 0 3			£390 0 3
5th year Dec. 31	To Transfer to Reserve Account	500 0 0	5th year Jan. 1	By Balance b/d.	390 0 3
			Dec. 31	" P. & L. Account	90 9 9
				" Cash (Interest)	19 10 0
		£500 0 0			£500 0 0

SINKING FUND INVESTMENT ACCOUNT

		£ s. d.			£ s. d.
1st year Dec. 31	To Cash	90 9 9	1st year Dec. 31	By Balance c/d.	90 9 9
2nd year Jan. 1	To Balance b/d.	90 9 9	2nd year Dec. 31	By Balance c/d.	185 10 0
Dec. 31	" Cash	95 0 3			
		£185 10 0			£185 10 0
3rd year Jan. 1	To Balance b/d.	185 10 0	3rd year Dec. 31	By Balance c/d.	285 5 3
Dec. 31	" Cash	99 15 3			
		£285 5 3			£285 5 3
4th year Jan. 1	To Balance b/d.	285 5 3	4th year Dec. 31	By Balance c/d.	390 0 3
Dec. 31	" Cash	104 15 0			
		£390 0 3			£390 0 3
5th year Jan. 1	To Balance b/d.	390 0 3	5th year Dec. 31	By Cash	390 0 3

LOAN ACCOUNT

			£				£
5th year				1st year			
Dec. 31	To Cash		500	Jan. 1	By Cash		500

Note to Illustration

At the end of the fifth year, no cash will be taken out of the business and invested, for the obvious reason that the loan is repayable on that date. Thus the difference between the total of the sinking fund, £500, and the total amount of the investments, £390 0s. 3d., *i.e.*, £109 19s. 9d., is made up as follows:

Final instalment of Sinking Fund uninvested	£90 9 9
Interest uninvested	19 10 0
	£109 19 9

The calculation of the amount of the instalment will be made as follows:

If an annual investment of £·180975 at 5 per cent compound interest will produce £1 at the end of five years, the amount of the annual investment required to produce £500 in the same period will be £·180975 × 500 = £90 9s 9d.

Any profit or loss on the sale of the investments must be credited or debited, as the case may be, to the Sinking Fund Account.

Illustration (2)

Assume that the facts are the same as in the previous example, but that the Investments were realised at a loss of £15 4s. 3d.

The Accounts for the last year would appear as follows:

SINKING FUND ACCOUNT

		£	s.	d.			£	s.	d.
5th year					5th year				
Dec. 31	To Sinking Fund Investment Account – loss on realisation ..	15			Jan. 1	By Balance b/d. ..	390	0	3
	„ Reserve Account	500			Dec. 31	„ P. & L. Account ..	90	9	9
						„ Cash (Interest) ..	19	10	0
						„ P. & L. Account – appropriation to meet loss on realisation of investments ..	15	4	3
		£515	4	3			£515	4	3

SINKING FUND INVESTMENT ACCOUNT

		£	s.	d.			£	s.	d.
5th year					5th year				
Jan. 1	To Balance b/d.	390	0	3	Dec 31	By Cash	374	16	0
						„ Sinking Fund Account – loss .	15	4	3
		£390	0	3			£390	0	3

Note. Since the investments realised £15 4s. 3d., less than their cost price, this amount must be provided out of general assets. In order, therefore, to maintain working capital, an equivalent amount must be appropriated from Profit and Loss Account.

Had a profit been realised, this could be taken either to Researve Account or to Profit and Loss Account, as the excess cash thus made available goes to swell the working capital.

§ 11. Secret Reserves

The term 'secret reserve' is used to denote reserves which actually exist but are not disclosed on the face of the Balance Sheet.

Secret reserves may arise in two ways, *viz.*, by the deliberate action of creating them, or by unrecorded appreciation in the value of assets. It would normally be unusual to write up assets in respect of an unrealised appreciation in value, hence the appreciation is not as a rule shown on the face of the Balance Sheet.

Secret reserves may be created deliberately by:

(1) Writing down assets below their actual value, *e.g.*, freehold premises or investments.

(2) Writing off assets altogether, although they are still of value.

(3) Creating excessive provisions for bad debts.

(4) Charging to revenue expenditure which is properly of a capital nature.

(5) Omitting goodwill from the accounts.

(6) Overstating liabilities in the Balance Sheet.

(7) Treating reserves for contingencies as provisions for specific liabilities.

(8) Grouping general reserves with actual liabilities, so as to inflate the latter on the Balance Sheet.

(9) Crediting exceptional or non-recurring profits direct to a contingencies reserve, and including such reserves in the liabilities on the Balance Sheet.

(10) Leaving undistributed revenue surpluses in the hands of subsidiary companies.

The following objections may be made against the practice of creating and maintaining secret reserves:

(1) The resulting Balance Sheet will not disclose the true state of affairs, as the assets will be under-stated and/or the liabilities over-stated.

(2) The Profit and Loss Account, where affected, will not show the correct profit, and consequently the dividend declared may be less than would otherwise have been possible.

(3) The practice could lend itself to the manipulation of profits, and to improper dealings in the shares of a company by persons who were aware of the existence of the secret reserves.

(4) If the fact that secret reserves have been drawn upon to maintain dividends is not disclosed in the published accounts, the fact that the revenue for the period for which the dividend was paid was insufficient for the purpose will not be known to the members. The true trading results of a period may thus be obscured.

(5) Assets, once depreciated, cannot be written up without attracting attention, whereas reserves for contingencies, being merged with creditors, can be manipulated with little risk of discovery. Hence overstatement of liabilities is open to more objection than undervaluation of assets.

(6) Revenue surpluses of subsidiary companies, ignored in good years and brought to credit in lean years can also hide the true figure of profit for the year. Such surpluses lend themselves to manipulation in unscrupulous hands.

On the other hand, the practice of creating secret reserves is undoubtedly advantageous in many instances, particularly in the case of banks, since it enables the dividends to be maintained without violent fluctuation, and prevents the credit of the bank being injured by the disclosure of exceptional losses, which though alarming to the uninitiated, do not in fact shake the stability of the concern.

The Companies Act, 1948, virtually prohibits the deliberate creation of secret reserves by companies, except in the case of banks and insurance companies, since it requires all reserves and provisions to be disclosed under suitable headings in the Balance Sheet. Where excessive provision is made for diminution in value of assets or for liabilities, the excess must be classified as a reserve.

§ 12. Suspense Accounts

A Suspense Account has already been referred to in connection with outstanding liabilities. As stated in that section, however, it is not usual to open a Suspense Account for dealing with such adjustments, but there may be occasions where such an account is necessary.

The principal use of a Suspense Account is to provide an account to which one aspect of the transaction can be posted temporarily until its correct destination is ascertained. Thus, if a trader received a bank note in settlement of an account without a covering letter, he should post the amount from the debit side of the cash book, to the credit of a Suspense Account, where it should remain until he discovers the name of the person from whom the amount was received, when it will be transferred from the Suspense Account to the credit of the personal account of the sender.

Suspense Accounts are frequently raised in respect of advertising and other expenses of a deferred revenue nature, where part of the benefit of the current expenditure will not be received until a subsequent period. In such cases it is permissible to carry forward the unexpired portion of the expenditure, in the same way as a payment in advance, and write it off against the revenue of the subsequent periods which benefit from the expenditure.

The use of Suspense Accounts should be avoided as much as possible, and care should be taken to see that any such accounts open at the date of the Balance Sheet are correctly shown therein, and that they are closed as soon as possible.

Where errors are revealed by the non-agreement of the Trial Balance, a Suspense Account is sometimes raised to balance the Trial Balance pending the discovery of the errors. In such a case, the rectification must be effected through this account in order that the original entry may be eliminated.

Illustration

Upon drawing up a Trial Balance a book-keeper finds that the credit total exceeds the debit total by £111 0s. 6d. and this amount is posted to a Suspense Account.

Subsequently, the following errors are discovered and you are required to show the Journal entries to effect the necessary corrections; also to give the Suspense Account shewing the adjustments made.

(*a*) Sale of Goods valued at £80 to J. Smith posted to W. Smith's account.

(*b*) Purchase valued at £20 from W. Adam posted to debit of his account.

(*c*) Sales Returns Book undercast by £100.

(*d*) Petty Cash Balance of £10 omitted from Trial Balance.

(*e*) Cost of Repairing Plant £45 6s. 0d. charged to Plant Account as £4 5s. 6d.

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		£ s. d.	£ s. d.
(*a*) J. Smith	*Dr.*	80 0 0	
To W. Smith			80 0 0
Being correction of posting made to wrong account.			
(*b*) Suspense Account	*Dr.*	40 0 0	
To W. Adam			20 0 0
Do.			20 0 0
Being correction of item of £20 incorrectly debited to W. Adam and posting of correct credit of £20.			
(*c*) Sales Returns Account	*Dr.*	100 0 0	
To Suspense Account			100 0 0
Being adjustment of error in cast of Sales Returns Book.			
(*d*) *Petty Cash	*Dr.*	10 0 0	
To Suspense Account			10 0 0
Being adjustment of omission of £10 balance.			
(*e*) Plant Repairs Account	*Dr.*	45 6 0	
To Plant Account			4 5 6
,, Suspense Account			41 0 6
Transferring cost of repairing plant erroneously charged to Plant Account as £4 5s. 6d.			

*This item will not be posted to the Petty Cash Account as the entry is necessary only to correct the omission from the Trial Balance.

SUSPENSE ACCOUNT

	£ s. d.		£ s. d.
To Difference in Books	111 0 6	By Sales Returns Account	100 0 0
,, W. Adam	40 0 0	,, Petty Cash	10 0 0
		,, Plant Repairs Account	41 0 6
	£151 0 6		£151 0 6

Notes to Illustration

(*a*) This error does not affect the agreement of the Trial Balance, the correct amount having been posted to the correct side of the ledger, although to the wrong account.

(*b*) In this case £20 has been posted to the wrong side of the ledger, thereby causing a difference in the Trial Balance of £40. The incorrect debit must be cancelled by a credit, and the correct credit made.

(*c*) The undercast in the Sales Returns Book causes the debit in the Sales Returns Account, and consequently the debit side of the Trial Balance, to be £100 short.

(*d*) The omission of the petty cash book balance from the Trial Balance causes the debit side to be £10 short.

(*e*) This involves an error of principle (*i.e.*, the posting of a revenue expense to a real account) as well as an error of commission. The incorrect debit to Plant Account must be cancelled by a *credit* to that account, the correct *debit* must be made to Repairs Account, and the resulting difference credited to Suspense Account.

A Suspense Account raised in respect of a difference in the Trial Balance must be closed before preparing the final accounts, by the adjustment of the differences as and when discovered.

If it proves impossible in the circumstances to discover the whole of the difference, and it is reasonably certain that this does not conceal any serious error, it may be necessary to write the balance off as a loss (if Dr.) or to carry it forward as a reserve (if Cr.). This should be a last resort, however.

MANUFACTURING ACCOUNTS; RECEIPTS AND PAYMENTS ACCOUNTS AND INCOME AND EXPENDITURE ACCOUNTS; THE PREPARATION OF FINAL ACCOUNTS FROM INCOMPLETE RECORDS

§ 1. Manufacturing Accounts

In a business whose operations include the manufacture, as well as the sale of commodities, it is usual for the Trading Account to be divided into two parts, *viz.*, (1) the Manufacturing (or Production) Account, which contains details of the cost of the goods produced, and (2) the Trading Account, which shows the gross profit realised on the goods sold.

The Manufacturing Account is designed to show not only the total cost of the goods manufactured, but the cost of each of the constituent elements which go to build up the total cost. The account is accordingly debited with the cost of the materials consumed, productive wages, and all other expenses attributable to the manufacturing operations, classified under appropriate headings.

It is desirable to present the items in such a way that reconciliation with the Cost Accounts is facilitated. Accordingly, the account should show the *Prime Cost*, *i.e.*, the total cost of the materials, productive wages and other expenses, which are capable of direct identification with production, and the *Works or Factory Cost*, which comprises the prime cost plus the various works indirect expenses, *i.e.*, expenses incurred in connection with production generally, but which cannot be associated directly with particular units of production. All expenses which contribute directly or indirectly to the cost of the goods, up to the point at which they are brought into a saleable condition, but excluding expenses of distributing or selling the goods, or of general administration, are debited to this account. After eliminating the value of any work in progress or unfinished goods on hand at the end of the period, the balance of the account represents the cost of the finished goods actually produced during the period, and is carried down to the debit of the Trading Account. The latter account is also debited with the opening stock of finished goods, and credited with the sales and with the closing stock of finished goods (the latter being preferably deducted from the sum of the opening stock and finished goods transferred from Manufacturing Account) in order to disclose the cost of, and the gross profit on the goods sold, the amount of which is transferred to the credit of Profit and Loss Account.

In some cases, instead of transferring finished goods produced from Manufacturing Account to Trading Account at cost price, they are transferred at a price approximating to the current market price. Where this is done, there will be a balance on the Manufacturing Account representing the profit or loss arising from manufacturing

the goods instead of purchasing them ready made. This profit or loss must be transferred to Profit and Loss Appropriation Account.

The items in the Profit and Loss Account should be marshalled in logical sequence and grouped under appropriate subheadings to show the total amount of the expenditure under each classification. Suitable groupings in a normal case are Administration, Selling, Distribution, Finance and (possibly) Miscellaneous, but any of these may be subdivided and additional classifications employed to meet the requirements of the particular business. The grouping of items in this way and the disclosure of group totals facilitates comparisons and may be of the greatest assistance to management.

The items in the Balance Sheet should also be grouped to show clearly, on the liabilities side, the total amounts of:

(i) the proprietor's capital;
(ii) reserves and other undistributed profits (these being added to the capital to disclose in one sum the amount of the proprietor's interest in the assets);
(iii) loans and other long-term liabilities; and
(iv) current liabilities;

and on the assets side the total amounts of:

(i) the fixed assets; and
(ii) the current assets.

Other classifications may be used, having regard to the nature of the business.

Illustration

Prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31st December, and Balance Sheet as at that date, of J. Smith, Manufacturer, from the following Trial Balance and information:

TRIAL BALANCE, 31ST DECEMBER	£	£
Advertising	830	
Bad Debts	605	
,, ,, Provision		1,000
Bank Charges	120	
J. Smith, Capital Account, 1st January		35,000
J. Smith, Current Account, 1st January		1,623
J. Smith, Drawings	8,000	
Discount		412
Factory Power	3,614	
Furniture	900	
General Expenses – Factory	205	
Office	346	
Insurance	902	
Light and Heat	482	
Plant and Machinery, 1st January	15,000	
,, ,, ,, bought 30th June	2,000	
Carried forward:	£33,004	£38,035

TRIAL BALANCE, 31ST DECEMBER (*continued*)

Brought forward:	£33,004	£38,035
Purchases	33,668	
Packing and Transport	1,085	
Rent and Rates	1,486	
Repairs to Plant	785	
Salaries – Office	3,690	
Sales		79,174
Stocks, etc., 1st January –		
Raw Materials	5,230	
Finished Goods	7,380	
Work in Progress (at prime cost)	1,670	
Wages – Factory	20,700	
Trading Debtors and Creditors	10,560	6,150
Cash at Bank	3,926	
Cash in Hand	175	
	£123,359	£123,359

Stocks, etc., at 31st December, were:	£
Raw Materials	3,560
Work in Progress	1,740
Work in Progress (at prime cost)	1,740
Finished Goods	9,650
Packing Materials	125

The following liabilities are to be provided for:	
Factory Power	562
Rent and Rates	386
Light and Heat	160
General Expenses – Factory	25
Office	40

Insurance paid in advance is £170.

Five-sixths of Rent and Rates, Light and Heat, and Insurance are to be allocated to the Factory and one-sixth to the Office.

Provide Depreciation at 10% per annum on Plant and Machinery and 5% per annum on Furniture.

Increase the Bad Debts Provision by £500.

The following Journal entries indicate how the adjustments required to be made in the above illustration may be incorporated in the accounts before preparing the final accounts.

JOURNAL

			£	£
Dec. 31	Stock Accounts	Dr.	15,075	
	To Manufacturing Account:			
	Raw Materials	..		3,560
	Work in Progress	..		1,740
	„ Trading Account:			
	Finished Goods .. .	..		9,650
	„ Profit and Loss Account:			
	Packing Materials .. .	..		125
	Stocks and Work in Progress at 31st December.		£15,075	£15,075
	Prepayments . .	Dr.	170	
	To Insurance			170
	Insurance paid in advance at 31st December.			
	Manufacturing Account .. .	Dr.	1,600	
	To Provision for Depreciation:			1,600
	Plant and Machinery			
	10% on £15,000 for 1 year £1,500			
	10% on £2,000 for ½ year 100			
	Profit and Loss Account ..	Dr.	45	
	To Provision for Depreciation:			
	Furniture, 5% on £900 ..			45
	Provision for depreciation for year.			
	Profit and Loss Account ..	Dr.	500	
	To Bad Debts Provision .			500
	Increase in provision for doubtful debts.			

MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 19..

	£	£		£
MATERIALS CONSUMED:			Transfer to Trading Account:	
Stock, 1st January	5,230		Cost of Goods produced	
Purchases .	33,668			
	38,898			
Less Stock, 31st December	3,560			
		35,338		
PRODUCTIVE WAGES		20,700		
		56,038		
Add Work in Progress, 1st January .		1,670		
		57,708		
Deduct Work in Progress, 31st December ..		1,740		
PRIME COST OF GOODS PRODUCED .		55 968		
WORKS INDIRECT EXPENSES:				
Factory Power .	4,176			
„ Rent and Rates	1,560			
„ Insurance .	610			
„ Light and Heat .	535			
General Expenses	230			
Plant Repairs . .	785			
„ Depreciation .	1,600			
		9,496		
WORKS COST OF GOODS PRODUCED		£65,464		
COST OF FINISHED GOODS SOLD:			SALES OF FINISHED GOODS	
Stock 1st January .	7,380			
Cost of Finished Goods produced	65,464			
	72,844			
Less: Stock, 31st December	9,650			
		63,194		
GROSS PROFIT ON SALES:				
Transferred to Profit and Loss Account		15,980		
		£79,174		£79,174

MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT (*continued*)

FOR THE YEAR ENDED 31ST DECEMBER, 19..

	£	£		£
ADMINISTRATION:				
Salaries	3,690		GROSS PROFIT FOR YEAR, b/d.	15,980
Rent and Rates	312			
Light and Heat	107		Discounts received ..	412
Insurance	122			
General Expenses	386			
Depreciation of Furniture	45			
		4,662		
SELLING AND DISTRIBUTION:				
Advertising	830			
Packing and Transport . ..	960			
		1,790		
FINANCE:				
Bank Charges	120			
Bad Debts	605			
Provision for Doubtful Debts ..	500			
		1,225		
NET PROFIT FOR YEAR		7,677		
Transferred to Current Account ..	..	8,715		
		£16,392		£16,392

Note:

In the above illustration, as the Work-in-Progress has been valued at prime cost, the adjustment for the values of opening and closing work-in-progress has been made before arriving at the prime cost of the goods produced. Where the valuation of work-in-progress includes an amount in respect of works indirect expenses, the adjustment for this part of the valuation should be made in the charge for such expenses in the Manufacturing Account.

J. SMITH

BALANCE SHEET AS AT 31ST DECEMBER

J. SMITH:			FIXED ASSETS:			
CAPITAL ACCOUNT:		35,000	Plant and Machinery at 1st January		£15,000	
			Additions at cost		2,000	
CURRENT ACCOUNT:						
Balance, 1st Jan.	£1,623				17,000	
Net Profit for year	8,715		*Less* Provision for Depreciation		1,600	
						15,400
	10,338		Furniture, at 1st January ..		£900	
Less Drawings	8,000		*Less* Provision for Depreciation		45	
		2,338				855
						16,255
		37,338	CURRENT ASSETS:			
CURRENT LIABILITIES:			Stocks:			
Trade Creditors ..	£6,150		Raw Materials ..		£3,560	
Expenses ..	1,173		Work in Progress		1,740	
		7,323	Finished Goods ..		9,650	
			Packing Materials		125	
					15,075	
			Book Debts	£10,560		
			Less Provision for Doubtful Debts	1,500		
					9,060	
			Prepayments ..		170	
			Balance at Bank ..		3,926	
			Cash in Hand		175	
						28,406
		£44,661				£44,661

The following is an alternative form of presentation of the Manufacturing, Trading and Profit and Loss Account, which is sometimes preferred.

MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 19..

			£
SALES			79,174
Deduct Cost of Sales:			
Cost of Materials consumed		35,338	
Productive Wages ..		20,700	
		56,038	
Add. Work in Progress, 1st January		1,670	
		57,708	
Deduct: Work in Progress, 31st December		1,740	
PRIME COST OF GOODS PRODUCED		55,968	
Add. WORKS INDIRECT EXPENSES:	£		
Factory Power .. .	4,176		
" Rent and Rates	1,560		
" Insurance	610		
" Light and Heat	535		
General Expenses ..	230		
Plant Repairs ..	785		
Plant Depreciation ..	1,600		
		9,496	
WORKS COST OF GOODS PRODUCED		65,464	
Add Stock of Finished Goods, 1st January		7,380	
		72,844	
Deduct: Stock of Finished Goods, 31st December		9,650	
			63,194
GROSS PROFIT ON SALES ..			15,980
Add· Discounts received			412
			16,392
Deduct:			
ADMINISTRATION:	£		
Salaries	3,690		
Rent and Rates ..	312		
Light and Heat ..	107		
Insurance	122		
General Expenses ..	386		
Depreciation of Furniture	45		
		4,662	
SELLING AND DISTRIBUTION:			
Advertising ..	830		
Packing and Transport	960		
		1,790	
FINANCE:			
Bank Charges	120		
Bad Debts	605		
Provision for Doubtful Debts	500		
		1,225	
			7,677
NET PROFIT FOR YEAR			£8,715

In cases where the goods produced are charged out from the factory to the selling department at a price in excess of manufacturing cost, it may be necessary, at the end of each accounting period, in order to arrive at the true profit, to provide in the accounts for the unrealised profit included in the valuation of the stock of finished goods carried forward. For example, if in the above illustration goods produced were charged from factory to selling department at a price which includes a profit of, say, 10 per cent on the invoice price, it would be necessary, on 31st December, to create a provision for the unrealised profit of 10 per cent on £9,650 = £965, by debiting Profit and Loss Account and crediting Provision for Unrealised Profit Account, the balance on the latter account being deducted from the stock figure for balance sheet purposes.

If a provision for unrealised profit had been brought forward from the previous period, it would only be necessary, at the end of the current period, to make such a transfer from Profit and Loss Account as would be required to adjust the existing provision by reference to the amount of the closing stock; for example, if in the above illustration a provision of 10 per cent on £7,380 = £738 had been created at the end of the previous period, it would now only be necessary to increase the provision to £965 by debiting Profit and Loss Account and crediting the provision account with £227.

Accounting Ratios

As has already been shown, the utility of Revenue Accounts and Balance Sheets is greatly enhanced by the collection of items of a like nature into appropriate groups, and the presentation of the accounts in a form in which these groups are clearly defined and suitably marshalled. Such accounts will enable various ratios to be calculated from which inferences may be drawn having an important bearing on the efficiency of management, not only in regard to the internal economy of the concern itself, but also by comparison with the achievements of other undertakings within the same industry.

The following are some of the more important Accounting Ratios.

Ratio to Sales of Cost of Sales and of Gross Profit

A comparison of these ratios from year to year may be a useful guide in determining price policy. It may also throw light on possible irregularities, *e.g.* a material overvaluation of closing stock may reduce the apparent cost of sales and increase the ratio of gross profit.

Ratio of Management and Administration Expenses to Sales

This shows the proportion of sales revenue absorbed by these overheads and by comparison of the ratios from year to year may be of assistance in formulating price and administration policy.

Ratio of Net Profit to Sales

This shows the final proportion of revenue accruing to the proprietors.

Ratio of Cost of Sales to Average Stock (Stock turnover)

This shows how many times the average stock is turned over during the accounting period, information which may be of great value in assessing buying efficiency. If, for example, the cost of sales is found to be approximately four times the cost of the stock normally carried, whereas experience of the particular trade shows that stock should be turned over more often than four times in a year, this would suggest that an unnecessarily large amount of capital is being locked up in stock.

Ratio of Sales to Debtors

This may throw light on the efficiency or otherwise of the credit control and debt collecting organisation of the concern, and might indicate whether an undue proportion of the book debts are overdue or possibly doubtful.

Ratio of Current Assets to Current Liabilities

This ratio may indicate whether the concern is normally able to meet its current

liabilities as they fall due out of current assets, and over a period of years may show whether the business is growing or declining in financial strength.

Ratio of Current Assets to Fixed Assets

This may be useful in comparing the pattern of the distribution of the concern's resources with other businesses in the same industry, and may give some indication as to whether the fixed assets are being utilized to their fullest capacity.

Ratio of Net worth (viz. Capital plus retained profits) to Fixed Assets

This ratio has come to be regarded as a test of the soundness of the capital structure of a concern, as it is associated with the view that the proprietors should provide the fixed capital and also some part of the working capital if financial security is to be maintained.

Ratio of Net Worth to Total Liabilities

This gives an indication of the interest in the concern of the proprietors, as compared with those of the creditors. The higher the net worth in relation to total liabilities the stronger the financial position will be.

Ratio of Net Income to Capital employed

This ratio gives an indication of the efficiency with which the business is being managed, and enables effective comparisons to be made between the earning power of the business and that of other businesses in the same industry, and between different periods.

§ 2. Receipts and Payments Account and Income and Expenditure Account

A RECEIPTS AND PAYMENTS ACCOUNT is a summary of cash transactions for a given period. It commences with the opening balance of cash in hand or at the bank, and is debited with all sums actually received, and credited with all cash paid away during the period to which the account relates, whether or not they have accrued during that period, and whether they are of a capital or revenue nature. The final balance is the balance of cash in hand, or the credit or debit balance at the bank, as the case may be, at the end of the period.

An INCOME AND EXPENDITURE ACCOUNT is, in effect, the Profit and Loss Account of a non-trading concern. It contains only items of a revenue nature, being debited with all expenditure, and credited with all income which relates to a particular period, whether or not it has actually been paid or received within that period. The final balance of an Income and Expenditure Account represents the excess of income over expenditure, or the excess of expenditure over income, as the case may be, for the period in question. This balance is analogous to the net profit or loss of a trading concern.

Receipts and Payments Accounts and Income and Expenditure Accounts are used commonly by such non-trading concerns as social clubs, societies, etc., for the purpose of presenting their financial position to their members. The Profit and Loss Account of a non-trading business, such as that of a professional firm, or of a property or investment company, is also often called an Income and Expenditure Account.

It cannot be too strongly emphasised that a Receipts and Payments Account is not

a proper substitute for an Income and Expenditure Account, since it deals only with cash transactions, and is not confined to those actually relating to the period covered by the account, or to transactions of a revenue nature, which alone must be considered in ascertaining the surplus or deficit of income for the period. A Receipts and Payments Account takes no account of income accrued but outstanding at the end of the period, or of expenditure or liabilities due but unpaid. The final balance represents the balance of cash in hand or at the bank, or the amount of the bank overdraft, and nothing more. It will be appreciated that where, for example, fixed assets have been sold and the proceeds received, or revenue has been collected, but a considerable amount of expenses or other liabilities remains unpaid, there may be a substantial cash balance when, in fact, income for the period has been overspent.

In order to prepare an Income and Expenditure Account from a Receipts and Payments Account, it is merely necessary to post all items of a revenue nature appearing in the Receipts and Payments Account to the *opposite* sides of the Income and Expenditure Account, after making such adjustments as may be necessary to give effect to accruals and prepayments at the beginning and end of the period respectively. Thus, such items as subscriptions, entrance fees, income from investments, etc., which have been received in cash and *debited* to the Receipts and Payments Account, must be *credited* to the Income and Expenditure Account, whilst expenditure such as rent, wages, repairs, etc., appearing on the *credit* side of the Receipts and Payments Account must be *debited* to the Income and Expenditure Account. Items of a capital nature appearing in the Receipts and Payments Account will be posted to the debit or credit, as the case may be, of the relevant asset or liability accounts, and will not affect the Income and Expenditure Account.

The Balance Sheet of a non-trading concern is prepared in the usual way, and contains particulars of all the assets and liabilities at the date as at which it is made up. The excess of the assets over the liabilities is analogous to the capital of a trader, but is usually called the Accumulated Fund, or General Fund, since it is normally made up of the excess of income over expenditure which has been accumulated within the concern. Separate accounts should be kept for funds raised for special purposes.

A variation of an Income and Expenditure Account is a RECEIPTS AND EXPENDITURE ACCOUNT. This is a revenue account similar in form to an Income and Expenditure Account, in which, however, credit is taken only for income actually received. Accrued income which has not been received in cash is ignored, although all expenditure for the period, whether paid or outstanding, is debited. Such an account is frequently prepared by professional businesses, such as those of solicitors, where it is desired to take no credit for income until it is actually realised, but at the same time to provide for all expenditure, whether paid or not. The balance of the account represents the most prudent estimate of the profit for the period.

Illustration

The Westminster Political Association prepared accounts for the year to December 31st.

(1) They started the year with £470 in the bank and finished up with an overdraft of £615, which was secured by the deposit of investments.

(2) They received subscriptions amounting to £835, of which £25 represented arrears, £760 current subscriptions and £50 paid in advance.

(3) They received £520 donations to the General Fund and £850 to the Election Fund, which had £15 in hand at Jan. 1st, and out of which £720 was paid for election expenses. There was no separate bank account.

(4) They held Government securities at Jan. 1st, which cost £2,000. Half were sold for £1,250 and the balance was valued at £1,200 at Dec. 31st. These investments produced interest of £35 (gross) during the year.

(5) Office premises were purchased during the year for £3,000 and a mortgage was arranged through a building society for £1,500. Legal expenses amounted to £105 and one instalment of £80 was paid to the society of which £45 was interest. Alterations and decorations of the premises cost £570, of which £150 was still owing.

(6) Office furniture was valued at £150 at Jan. 1st. £170 was paid for additions during the year and £70 was still owing. Depreciation is estimated at 10 per cent. per annum.

(7) The only other receipt was £75 for sale of literature, which cost £120. £60 worth was given away.

(8) Other payments were:

Agent's salary and expenses ..	£700 (£50 drawn in advance)
Office salaries	£350
Rent and rates	£170 (£50 owing at Jan. 1st)
Meetings and propaganda ..	£165 (£30 in respect of a meeting to be held in the new year.)
Stationery, postage and sundries	£150

Prepare a Receipts and Payments Account and an Income and Expenditure Account for the year ended Dec. 31st, and a Balance Sheet as at that date.

THE WESTMINSTER POLITICAL ASSOCIATION

Receipts and Payments Account for the Year ended 31st December

						£
Jan. 1	To Balance b/f.		Dec. 31	By Election Expenses		720
Dec. 31	„ Subscriptions			„ Cost of Premises	£3,000	
	„ Donations			„ Legal Expenses	105	
	„ Election Fund				£3,105	
	„ Sale of Securities			*Less* Mortgage .. .	1,500	
	„ Interest Received					1,605
	„ Sale of Literature			Building Society Payments .		80
	„ Balance c/f.			Alterations and Decorations		420
				Office Furniture		170
				Agent's Salary		700
				Office Salaries		350
				Rent and Rates		170
				Meetings, etc.		165
				Stationery and Postage		150
				Cost of Literature ..		120
						£4,650

INCOME AND EXPENDITURE ACCOUNT

for the Year ended 31st December

		£		£
To Agent's Salary and Expenses		650	By Subscriptions Receivable	760
„ Office Salaries		350	„ Donations	520
„ Rent and Rates		120	„ Interest on Investments (gross)	35
„ Stationery, Postage and Sundries		150	„ Balance, being Excess of Expenditure over Income for the year	219
„ Meetings and Propaganda ..		135		
„ Cost of Literature distributed	£60			
Less Profit on Sales ..	15			
		45		
„ Interest on Mortgage ..		45		
„ Depreciation of Office Furniture		39		
		£1,534		£1,534

BALANCE SHEET AT 31ST DECEMBER

General Fund:			Office Premises at cost (including legal expenses)	3,675	
Balance at Jan. 1st	2,580		*Less* Mortgage	1,465	
Add: Profit on Sale of Investment	250				2,210
	2,830		Office Furniture:		
Less Excess of Expenditure over Income for year	219	2,611	Balance at Jan. 1st	150	
			Additions at cost	240	
Election Fund:				390	
Balance at Jan. 1st	15		*Less* Depreciation written off	39	
Donations	850				351
	865				2,561
Less Election Expenses	720	145	Investments at cost (Market Value, £1,200)		1,000
Subscriptions in Advance		50	Payments in Advance		80
Bank Overdraft		615			
Sundry Creditors		220			
		£3,641			£3,641

Note. The balance on the General Fund at January 1st is calculated as follows:

Bank (excluding Election Fund)	£455
Subscriptions in arrears	25
Investments	2,000
Office Furniture	150
	2,630
Less Rent accrued at January 1st	50
	£2,580

§ 3. The Preparation of Accounts from Incomplete Records

For the purpose of this section the expression 'incomplete records' is intended to signify any accounting records which fall short of complete double entry. There are varying degrees of incompleteness, and the procedure to be adopted in order to prepare final accounts must depend upon the nature of the records and data available. In extreme cases it may be found that there are no records whatever of the day to day transactions, owing either to neglect on the part of the trader to keep them, or to the destruction of the books and vouchers by a fire on the trader's premises, or through some other cause. In such circumstances, accounts would have to be built up largely from estimates obtained by exhaustive enquiry and the careful sifting of whatever evidence can be found. In other instances books may have been kept by 'single entry', or data may be available by means of which double entry can be effected in total and a Profit and Loss Account and Balance Sheet extracted when this has been done.

Strict 'SINGLE ENTRY' takes account only of the personal aspect of transactions, and leaves the impersonal aspect entirely unrecorded. It is rarely, if ever, met with in practice, as in almost every case it will be found that some cash records, even though incomplete, have been kept. In any event, there will usually be a bank account, and the pass book or statement supplied by the bank will provide details of the operation of that account.

Assuming such to be the case, the following procedure should be followed in order to prepare a Profit and Loss Account and Balance Sheet.

(1) A Statement of Affairs at the commencement of the period under review should first be drawn up. In order to prepare this statement, particulars must be obtained of the assets and liabilities of the business at that date. The balance at the bank can be ascertained from the bank statement. The values of any fixed assets can be obtained from such details as the trader is able to supply of their cost and the dates upon which they were acquired, provision for depreciation from the date of acquisition to the commencement of the current period being deducted. The trader must provide an estimate of the value of his stock in trade, and particulars of any book debts and liabilities. Accounts should be opened, to the debit of which the amounts of the estimated values of the assets should be posted. The total of the book debts should be debited to a Total Debtors Account, and the total of the liabilities credited to a Total Creditors Account. The excess of the aggregate of the assets over the liabilities may be taken to represent the amount of the trader's capital at the commencement of the period, and should be credited to his Capital Account.

(2) A careful analysis should now be made of the bank pass book or statement, and a Cash Summary (or Receipts and Payments Account) prepared. For this purpose, analysis sheets should be used, in which columns should be provided for each of the principal headings of receipts and payments. For example, the lodgments into the bank may be analysed under the headings of cash takings, income from investments, the sale of assets, new capital paid in and private income of the trader. Payments from bank should be analysed as between payments for goods purchased, rent, rates, insurances and other business expenses, cheques cashed for wages, petty cash and personal expenditure, and cheques drawn for the trader's private purposes. It must be seen that the cross-casts of the analysis columns agree with the total columns.

(3) Enquiry should be made as to the amounts of any cash takings which have not been paid into the bank, but have been used by the trader for the payment of business expenses, goods purchased for cash and personal expenses. An estimate should also be obtained of the value of any stock in trade which may have been withdrawn by the trader for his own personal use or for that of his family.

(4) On completion of the above analysis, postings will be made as follows:

(i) From the debit side of the Cash Summary:

(*a*) Cash takings to the credit of Total Debtors Account.

(*b*) Income from investments (if any) to the credit of Income from Investments Account.

(*c*) Proceeds of sale of assets (if any) to the credit of the appropriate asset accounts.

(*d*) Other items to the credit of the relevant accounts.

If a profit or loss on the sale of assets is disclosed, this should be transferred either to Profit and Loss Account or to the proprietor's Capital Account.

(ii) From the credit of the Cash Summary—

(*a*) Payments for goods purchased to the debit of Total Creditors Account.

(*b*) Payments of expenses to the debit of the relevant nominal accounts.

(*c*) Cheques drawn for petty cash to the debit of Petty Cash Account.

(*d*) The proprietor's personal drawings to the debit of his Current Account.

(*e*) The purchase of assets (if any) to the debit of the respective asset accounts.

The amount of any cash takings used for business or private purposes should be journalised, the appropriate nominal accounts or the proprietor's Current Account (as the case may be) being debited and Total Debtors Account credited. The usual adjustments for outstandings and payments in advance may now be made. A schedule should be compiled from such memoranda as the trader has kept, of the book debts outstanding, the total of which should be credited and carried down in the Total Debtors Account. The balance of this account will now represent the total sales for the period and should be transferred to the credit of Trading Account.

Similarly, a schedule should be made of liabilities outstanding to trade and other creditors, the amounts being checked with the creditors' statements, and the total thereof debited and carried down in the Total Creditors Account. The balance of this account will now represent the total purchases for the period, and should be transferred to the debit of Trading Account.

The whole of the transactions will now be recorded in total in double entry form and it will be possible to extract a Trading and Profit and Loss Account and Balance Sheet in the usual way.

The percentage of gross profit revealed by the Trading Account may afford some indication as to the accuracy or otherwise of the data and estimates used in compiling the accounts. If it is found that this percentage is substantially lower than the percentage of gross profit normally earned in the particular trade, doubt would be thrown on the accuracy of the opening or closing stocks, purchases or sales, and further enquiry would be necessary. In particular, information should be elicited as to the style in which the trader lives. It will often be found that the amount of cash takings alleged to be withdrawn for private use is wholly incompatible with the size and character of the trader's domestic establishment and mode of life, and a re-estimation of the amount of the personal drawings might be necessary.

Illustration (1)

A is the proprietor of a grocery and general stores. He has not previously engaged an accountant. He informs you that this year the Inspector of Taxes refuses to accept the account A has supplied of his trading results for the year ended 31st March, 1959. That account is as follows:

	£		£
Payments for goods ..	9,495	Takings	10,930
Payments for expenses ..	1,130		
Profits	305		
	£10,930		£10,930

He instructs you to examine his records and prepare accounts.

From your examination of the records and from interviews with your client, you ascertain the following information:

(1) The takings are kept in a drawer under the counter; at the end of each day the cash is counted and recorded on a scrap of paper; at irregular intervals Mrs. A transcribes the figures into a notebook; a batch of the slips of paper was inadvertently destroyed before the figures had been written into the notebook, but Mr. and Mrs. A carefully estimated their takings for that period, and the estimated figure is included in the total of £10,930.

(2) The following balances can be accepted:

	31st March 1958	31st March 1959
	£	£
Cash in hand	45	87
Balance at Bank	156	219
Good debts	458	491
Creditors for purchases of stock	279	243
Stock in trade at cost	1,950	1,900

(3) Debts totalling £356 were abandoned during the year as bad; the takings include £25 recovered in respect of an old debt abandoned in a previous year.

(4) A rents the shop and living accommodation on a weekly tenancy for £3 per week including rates; the rent is included in expenses £1,130. The living accommodation may be regarded as one-third of the whole.

(5) The expenses total also includes:

(i) £35 running expenses of A's private car;

(ii) £60 for exterior decoration of the whole premises, the landlord having refused to have this done;

(iii) £160 for alterations to the premises to enlarge the storage accommodation.

(6) A takes £10 per week from the business and hands it over to his wife, who pays all the household and personal expenses except those referred to below.

(7) A pays for his own cigarettes and beer with cash taken from the drawer; this is estimated at £1 10s. per week.

(8) A competed in a football pool for 30 weeks of the year, staking £1 each week, buying a postal order with cash taken from the drawer; his winnings totalled £59.

(9) During the year A bought a secondhand car (not used for business) from a friend; the price agreed was £350, but as the friend owed A £67 for goods supplied from the business the matter was settled by a cheque for the difference.

(10) An assurance policy on A's life matured and realized £641.

(11) A cashed a cheque for £100 for a friend: the cheque was dishonoured and the friend is repaying the £100 by instalments. He had paid £40 by 31st March, 1959.

(12) Other private payments by cheque totalled £96 plus a further sum of £110 for income tax.

(13) You are to provide forty guineas for accountancy fees.

You are required to prepare:

(*a*) A Balance Sheet of the business as at 31st March, 1958;

(*b*) A Profit and Loss Account for the year ended 31st March, 1959; and

(*c*) A Balance Sheet for the business as at 31st March, 1959.

A

BALANCE SHEET AS AT 31ST MARCH, 1958

	£		£
A, Capital Account	2,330	Stock ..	1,950
Creditors ..	279	Debtors ..	458
		Balance at Bank	156
		Cash in Hand	45
	£2,609		£2,609

TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 1959

	£		£
Stock, 1/4/58	1,950	Sales	11,638
Purchases	9,459		
	11,409		
Less Stock 31/3/59	1,900		
	9,509		
Gross Profit, carried down ..	2,129		
	£11,638		£11,638
Rent and Rates ($\frac{2}{3}$ of £3 per week) . ..	104	Gross Profit, brought down	
Sundry Expenses	719	Bad Debts recovered ..	
Cost of enlarging storage accommodation ..	160		
Repairs ($\frac{2}{3}$ of £60)	40		
Bad Debts written off	356		
Accountancy Fees	42		
Net Profit for year	733		
	£2,154		£2,154

Note. The cost of enlarging storage accommodation could be capitalised, but it has been thought better to write it off.

BALANCE SHEET AS AT 31ST MARCH, 1959

				£
A. Capital Account:			Stock, at cost	1,900
Balance at 1/4/58	2,330		Sundry Debtors	491
Net Profit for year	733		Balance at Bank	219
			Cash in Hand	87
	3,063			
Less Drawings	651			
		2,412		
Liabilities:				
Trade Creditors	243			
Accountancy Fees	42			
		285		
		£2,697		£2,697

Note. The working accounts would appear as follows:

CASH SUMMARY

	£		£
Balances 1/4/58 (Cash £45; Bank £156)	201	Expenses	1,130
Bad debt recovered	25	Purchases	9,495
Football Pool winnings	59	Cash Drawings	520
Insurance Policy	641	Personal Cigarettes, etc. .	78
Repaid by Friend	40	Football Pools	30
Balance = Cash Takings carried to Total Debtors Account	11,182	Car	283
		Loan to Friend	100
		Drawings by cheque	96
		Income Tax . ..	110
		Balance 31/3/59 (Cash £87; Bank £219)	306
	£12,148		£12,148

TOTAL DEBTORS

	£		£
Debtors 1/4/58	458	Cash Takings	11,182
Balance — Sales	11,638	Friend re Car	67
		Bad Debts w/o	356
		Debtors 31/3/59	491
	£12,096		£12,096

TOTAL CREDITORS

	£		£
Cash	9,495	Creditors 1/4/58	279
Creditors 31/3/59	243	Balances — Purchases	9,459
	£9,738		£9,738

EXPENSES

	£		£
Cash	1,130	Rent	156
		Car Expenses	35
		Repairs to premises	60
		Alterations	160
		Balance = Sundry Expenses	719
	£1,130		£1,130

DRAWINGS

	£		£
Cash	520	Football Pool Winnings	59
Cheques	96	Life Policy Money	641
Rent (one-third of £3 per week)	52	Repayments by Friend	40
Private Car Expenses	35	Balance — Net Drawings	651
Decorations (House) (one-third of £60)	20		
Sale of Car	350		
Cash paid to Friend	100		
Cigarettes, etc.	78		
Football Pools	30		
Income Tax	110		
			£1,391

Where the available records are so deficient that it is impossible to compile a reasonably complete cash summary, the only method of estimating the profit or loss for the period is to prepare Statements of Affairs showing the 'net worth' of the business at the beginning and at the end of the period respectively.

A Statement of Affairs for this purpose is a document in the form of a Balance Sheet, showing on one side the estimated amounts of the various assets and on the other the liabilities, the difference between the two sides representing the proprietor's 'net worth', or capital at the date of the statement.

If a Statement of Affairs has been drawn up at the end of the preceding period, the opening capital for the current period would be shown thereby. It would then be necessary to prepare a similar statement at the end of the current period, and to find the difference between the opening and closing figures of capital, the amount of which, after adding back any sums withdrawn, and deducting any new capital introduced, would represent the profit or loss for the period.

Illustration (2)

J.'s last Statement of Affairs prepared at 1st January, was as follows:

STATEMENT OF AFFAIRS, 1st January, 19....

	£		£
Creditors	6,000	Office Furniture	500
Bills Payable	500	Stock ..	2,000
Capital Acounts – being excess of assets over liabilities at this date	3,000	Debtors ..	4,500
		Bills Receivable	1,000
		Cash ..	1,500
	£9,500		£9,500

On 31st December, he finds his liabilities to be: Creditors £4,500, Bills Payable £700. And his assets; Office Furniture £450, Stock £1,500, Debtors, £5,300, Bills Receivable £700, Cash £800. His drawings during the period have amounted to £450. What profit has he made?

STATEMENT OF AFFAIRS, 31st December

			£
Creditors	4,500	Office Furniture	450
Bills Payable	700	Stock ..	1,500
Capital Account – being excess of assets over liabilities at this date	3,550	Debtors	5,300
		Bills Receivable	700
		Cash ..	800
	£8,750		£8,750

	£
Capital 31st December .	3,550
Add Drawings for the year	450
	4,000
Less Capital 1st January ..	3,000
Net Profit for year ..	£1,000

No great difficulty should be experienced in arriving at fair estimates of the values of the assets and liabilities at the end of the period under review, provided that the work of preparing the statement is undertaken shortly after that date, when the necessary material for the valuation will probably be still accessible. The preparation of earlier statements may present more difficulty, and the most searching enquiries will have to be made, the nature of which will depend upon the facts of the case. Needless to say, this method of ascertaining results is most unsatisfactory, and the trader should be advised to instal double entry book-keeping without delay.

CHAPTER V

GOODS ON SALE OR RETURN, CONSIGNMENT ACCOUNTS, ETC.

§ 1. Treatment of Goods sent on Sale or Return

Where goods are sent out on approval, such transactions should not be treated in the books as sales, since the property in the goods does not pass to the buyer until he signifies to the seller his acceptance of them, or does some act by means of which a sale is expressed or implied. If, therefore, these transactions are recorded as sales, profit will be anticipated which may never actually be realised, and the Balance Sheet will not exhibit the true state of affairs.

The method of treatment in the books depends upon circumstances and the number of transactions involved, and may be broadly considered under three headings:

(a) Where the number of Sale or Return transactions is small

The best way to record these transactions is to have a specially ruled form of day book, such as the following:

SALE OR RETURN DAY BOOK

Date	Particulars	Goods sent on Sale or Return	Date	Goods Returned	Goods Sold	Sales Ledger Folio
(1)	(2)	(3)	(4)	(5)	(6)	(7)

The procedure will be as follows:

(1) When goods are sent out they are entered in Column 3 at selling price, and no other entry is made until definite information has been obtained as to whether the goods are to be kept by the customer or returned.

(2) If the goods are returned, their value is extended into Column 5, which like Column 3, is simply a memorandum column, and does not affect the double entry.

(3) If the goods are sold, their value is extended into column 6, and posted therefrom to the debit of the customer's account in the sales ledger. The total of this column will ultimately be posted to the credit of Sales Account in the impersonal ledger.

(4) The difference between the totals of columns 5 and 6 taken together, and that of column 3, will represent the selling price of the goods out on approval at any given date.

(5) All these transactions will have been entered in the sale or return day book at selling price, but for Balance Sheet purposes the stock of goods out on approval must be valued at cost, and treated in the same way as stock in hand.

(b) Where the number of Sale or Return transactions is considerable

The system outlined above cannot conveniently be applied without some modification where the number of sale or return transactions is considerable, owing to the possibility that a large number of items will be outstanding at the balancing date.

In order to avoid the labour of bringing forward in detail full particulars of these outstanding items to a fresh section of the book, which would be necessary to enable the various columns to be properly balanced off, a slightly extended ruling of the book is suggested.

The following will be found suitable:

SALE OR RETURN DAY BOOK

		Half year ending........................						Half year ending.				
Date	Particulars	Goods sent on Sale or Return	Date returned or sold	Goods returned	Goods sold	Sales Ledger Folio	Balance 30th June	Date returned or sold	Goods returned	Goods sold	Sales Ledger Folio	Remarks

At the balancing date the selling price of the goods remaining in the hands of customers will be extended into the *Balance* column, and all the columns in the first section cast. The total of the *Balance* column, plus the totals of the *Goods Returned* and *Sold* columns, will equal the total in the *Goods sent out on Sale or Return* column.

In the following period, as these goods are sold or returned, the amounts will be extended into the columns provided, and this should suffice to complete the record, since it is unlikely that any items will remain open beyond the close of the second period. Any such goods still outstanding should be transferred to the next period's records, or called in.

A further section of the book will be utilised to record all goods sent out during each subsequent period, and these in their turn will be completed in a similar manner.

(c) Where the number of Sale or Return transactions is large, and the goods are of considerable value

In these circumstances it is not wise to rely on a purely memorandum system, which does not readily lend itself to proof. It is preferable to have a separate set of books kept on double entry principles.

These will comprise the following:

(1) Sale or Return Ledger.

(2) Sale or Return Day Book.

(3) Sale or Return Journal.

The procedure will then be as follows:

(1) When goods are sent out they are entered in the sale or return day book, and posted therefrom in detail to the debit of the customer's account in the sale or return ledger, and in total at the end of each month or period to the credit of a Sale or Return Total Account, which can be kept in the sale or return ledger.

(2) When the customer intimates his decision to keep the goods, his account in the sale or return ledger must be credited and the Sale or Return Total Account debited. The customer's account in the sales ledger must then be debited (since he is now a debtor) and Sales Account credited. When goods are returned, the customer's account in the sale or return ledger must be credited and the Sale or Return Total Account in the same ledger debited. To record these transactions it is necessary to have a special sale or return journal, which should be ruled as follows:

SALE OR RETURN JOURNAL

Date (1)	Particulars (2)	S. or R.L. Folio (3)	Sale or Return Ledger (4)	S. L. Folio (5)	Sales Ledger (6)

(3) When goods out on sale or return are sold, the customer's name is entered in column 2, and the amount of the sale entered in columns 4 and 6, and posted in detail therefrom to the credit of the customer's account in the sale or return ledger, and to the debit of his account in the sales ledger.

(4) When goods are returned, they are simply entered in column 4, and posted in detail therefrom to the credit of the customer's account in the sale or return ledger.

(5) At the end of each period the total of column 6 is posted to the credit of Sales Account, and that of Column 4 to the debit of Sale or Return Total Account in the sale or return ledger.

The main principle of the system above described is to render the sale or return ledger self-balancing, *i.e.*, the total of the debit balances in the ledger should equal the balance of the Sale or Return Total Account. If this is carried out, there is no difficulty in ascertaining the total selling value of goods out on sale or return at any time.

On preparing final accounts, the sale or return ledger, being self-balancing, is outside the double entry, and the actual value of the goods out on sale or return, which should be treated as stock, can be arrived at by reducing the balance of each account in the sale or return ledger to the cost price of the goods.

It sometimes happens that goods sent out on sale or return are erroneously entered in the sales day book as if they were actual sales, and posted therefrom to the debit of the customers' accounts in the sales ledger. They are thus included in the total amount posted to the credit of Sales Account. Where goods sent out on sale or return have been treated in this way it is necessary, when preparing the final accounts, to eliminate the items from the Debtors' Accounts and Sales Account respectively, and include the goods, at cost price or under, in the closing stock figure, in the Trading Account and Balance Sheet; otherwise credit will be taken for a profit which has not yet been realised.

In order to obviate the necessity of making an adjusting entry in each individual debtor's account, the total selling price of all the outstanding items may be debited, in one sum, to Sales Account, and credited to a special account called Sale or Return Suspense Account, the balance of which should be deducted from the total of the book debts for Balance Sheet purposes. These goods will then be valued at or below cost price, and included in the value of the stock in trade which is credited to Trading Account and debited to Stock Account.

Illustration

In preparing the final accounts of a company it is found that the amount of the Sundry Debtors, £42,167, includes £4,000 worth of goods sent out on approval, and debited to customers' accounts, in respect of which the time for returning the goods had not yet expired. These goods have been invoiced at $33\frac{1}{3}\%$ above cost.

In preparing the final accounts the following journal entry should be made:

JOURNAL

		£	£
Sales Account	*Dr.*	4,000	
To Sales or Return Suspense Account			4,000
Adjusting goods out on Sale or Return treated as Sales.			

The £4,000 debited to Sales Account will reduce the sales figure credited to Trading Account, whilst the £4,000 credited to Sale or Return Suspense Account will be deducted from the figure of Sundry Debtors, which will thus appear in the Balance Sheet as £38,167. The goods will then be valued at cost, *viz.* £3,000, and included in the value of the stock in trade.

In subsequent years, if the same procedure is continued, it will only be necessary to increase or decrease (as the case may be) the balance on the Sale or Return Suspense Account to the amount of the outstanding sale or return items as at the date of balancing the accounts, the corresponding entry being a debit or credit to the Sales Account.

§ 2. Consignment Accounts

In some businesses it is the practice to consign goods to agents for sale on commission, the goods remaining the property of the consignors until they are sold. In such cases,

the agents must not be debited with the value of the goods, since they do not purchase them. When, however, an agent has sold the goods and received the proceeds, he becomes indebted to the consignor for the sums received, less his expenses and commission, and accounts to the consignor by means of an ACCOUNT SALES, which shows particulars of goods sold, the price realised, the agent's charges, brokerage and commission deducted, and the net balance for which he is liable.

Illustration

On 1st March 19.., the A. Mining Company Limited, consigned to B. Jones and Co 160 tons of Chrome Ore per S.S. 'Menelaus', invoiced at £7 per ton. The cost of the Ore at the mine was 50s. per ton = £400 and Railway Freight to the coast £140, all other expenses being paid by the consignee. On 1st July, B. Jones and Co. remitted an Account Sales showing gross weight 160 tons, and tare of bags 10 cwt, the Ore being realised at 160s. per ton. They deducted for Ocean Freight 45s. per ton, for Dock Dues, etc. £90, Marine Insurance £15, Brokerage 1¼ per cent, and Commission 2½ per cent, remitting a draft for the balance. Make out an Account Sales.

ACCOUNT SALES of 160 tons of Chrome Ore *ex S.S.* 'Menelaus', sold by order and for account of the A. Mining Company Limited

By B. JONES & CO.,
5 John Street,
London, 1st July 19..

Discharged	160 tons 0 cwt.		
Tare of Bags	10 ,,		
	159 ,, 10 ,, @ 160s.		£
	..		1,276
CHARGES		£	
Ocean Freight at 45s. per ton		360	
Dock Dues, etc.		90	
Marine Insurance		15	
Brokerage at 1¼% on £1,276		16	
Commission 2½% on £1,276		32	
			513
Net proceeds as per draft enclosed ..	..		£763

E. & O. E.,
London, 1st July 19..
(Signed) B. JONES & CO.

Since the consignee sells the goods as agent for the consignor, where sales are made on credit the purchaser becomes the debtor of the consignor, not of the consignee, and if the debtor makes default in payment, it is the consignor who suffers the loss. Sometimes, however, in consideration of an additional commission, called a *del credere* commission, the consignee will indemnify the consignor against loss in respect of any transactions effected by the consignee on the consignor's behalf. Such an agent is called a *del credere* agent. In effect, he guarantees the payment of any debts created by his agency, and undertakes to bear the loss should any of them prove to be irrecoverable.

§ 3. Entries in the Consignor's Books

When the consignor wishes to ascertain the exact profit or loss in respect of each consignment, he should open a separate Consignment Account therefor. Each Consignment Account then constitutes a Profit and Loss Account in respect of the transaction to which it relates.

A personal account must be opened for the consignee. Care must be taken to post to this account only transactions which create or discharge liabilities between the consignor and consignee, *e.g.*, the payment of cash or the charges for expenses and commission. No entry must be made in this account when goods are sent to the consignee, since he does not become a debtor in respect of such goods.

The procedure should be as follows:

(1) Debit Consignment Account with the *cost* of the goods, and credit a 'Goods sent on Consignment Account'. (Even though the goods are invoiced *pro forma* to the consignee at an inflated price, only their *cost* price should be debited to Consignment Account, since the function of this account is to show the consignor's profit or loss on the consignment.)

(2) Debit Consignment Account with expenses incurred by the consignor, such as insurance, freight, etc., crediting cash or the relevant personal accounts.

(3) On receipt of the Account Sales from the consignee, debit the Consignee's Account and credit the Consignment Account with the gross proceeds.

(4) Debit the Consignment Account with expenses, brokerage and commission deducted by the consignee, crediting the Consignee's Account.

(5) When the whole of the goods have been sold, the balance of the Consignment Account will represent the profit or loss on the consignment, and be transferred to Profit and Loss Account.

(6) The balance of the Consignee's Account will represent the amount due by or to him. If he remits by bill, Bills Receivable Account will be debited and the Consignee's Account credited, so closing that account. If a draft or cheque is forwarded, cash will be debited.

(7) Transfer the balance of the Goods sent on Consignment Account to the credit of Trading Account (or Purchases Account). The total purchases debited to Trading Account include these goods and the cost price of such goods must obviously be eliminated from the Trading Account, since they are fully accounted for in the Consignment Account. If they were not so credited, the cost of sales would be inflated, so that the Trading Account would not show the true gross profit on the ordinary turnover.

Occasionally, by special arrangement, the consignor draws a bill of exchange on the consignee as soon as the goods are forwarded, in which case the amount of the bill will be credited to the Consignee's Account. If the goods are never sold, and therefore returned, the bill will have to be cancelled or the consignee reimbursed. Such an arrangement enables the consignor, if he so desires, to discount the bill and place himself in funds to that extent in anticipation of the sale of the goods. The term of the bill will be such that the consignee can reasonably anticipate that he will have sold sufficient goods to realise the funds to meet the bill by the time it becomes due.

The amount of any such bill will rarely be equal to the full value of the goods, as the consignee will want to retain out of the proceeds, when the goods are sold, a sum to meet expenses, and commission. When the consignee sends in his Account Sales, he takes credit for the bill, in whole or proportionately to the goods sold, according to the arrangement.

Illustration (1)
From the particulars given in the Account Sales on page 94, make the entries in the Consignor's books.

CONSIGNOR'S BOOKS

CONSIGNMENT ACCOUNT

19..			19..		£
Mar. 1	To Goods sent on Consignment –		July 1	By B. Jones & Co. - Sales	1,276
	Ore	400			
	„ Railway Freight .	140			
July 1	„ B. Jones & Co. –				
	Ocean Freight	360			
	Dock Dues .	90			
	Marine Insurance ..	15			
	Brokerage	16			
	Commission	32			
Dec 31	„ Profit and Loss Account –				
	Profit	223			
		£1,276			£1,276

B. JONES & CO.

19..		£	19.		
July 1	To Consignment Account – Sales	1,276	July 1	By Consignment Account	
				Sundry Charges	513
			„ 23	„ Cash ..	763
		£1,276			£1,276

GOODS SENT ON CONSIGNMENT ACCOUNT

19..		£	19..		£
Dec. 31	To Trading Account	400	Mar. 1	By Consignment Account –	
				Ore	400
		£400			£400

Should the consignor prepare his Balance Sheet and accounts prior to the sale of the goods, the debit balance on the Consignment Account will be carried forward, and treated in the Balance Sheet as stock on consignment. If a loss is anticipated, adequate provision therefor should be made.

Where only part of the goods has been sold at the date upon which the Account Sales is rendered, the unsold stock should be brought down as a balance on the Consignment Account, being valued at the cost price of the goods. A relevant proportion of the expenses already incurred by the consignor and consignee in placing the goods in a saleable condition at the consignee's warehouse (but not of the expenses incurred in selling the goods) may be included in the valuation, and thus carried forward. If

the current market value is less than cost, then the stock must be written down accordingly. This procedure discloses the correct profit or loss upon the goods actually sold. On no account should selling expenses be taken into account in valuing stock.

Illustration (2)

Applying the same particulars of the consignment as shown in the Illustration (1), it is found that the A. Mining Co. Limited, consigned to B. Jones & Co., 160 tons of Chrome Ore costing 50s. per ton at the mine = £400, and the railway freight amounted to £140. The A. Mining Co.'s financial year ended on 31st May 19.., and at that date only 79 tons, 10 cwts of the Ore had been sold, the cost price of Ore at the mine-head on 31st May being 45s. per ton. At the Mining Co.'s request B. Jones & Co. supplied an Account Sales, dated 31st May, giving the following particulars:

	Tons	cwt.				£
Net landed weight	159	10				
Sold	79	10	@ 160s. ..			636
	80	0				
Charges on Whole Consignment –				£		
Ocean Freight				360		
Dock Dues, etc.				90		
Marine Insurance				15		
					465	
Brokerage 1¼% on £636 ..					8	
Commission 2½%					16	
						489
Net Proceeds						£147

Show the Consignment Account and Goods sent on Consignment Account in the Consignor's Books.

CONSIGNOR'S BOOKS

CONSIGNMENT ACCOUNT

19..		£	19..		£
Mar. 1	To Goods sent on Consignment – Ore	400	May 31	By B. Jones and Co.	636
	„ Railway Freight	140		„ Balance carried down – 80 tons @ 45s. plus shipping and landing charges	483
May 31	„ B. Jones & Co. – Charges on whole Consignment	465			
	„ B. Jones & Co. – Brokerage on Sales	8			
	Commission on Sales	16			
	„ Profit and Loss Account Profit	90			
		£1,119			£1,119
June 1	To Balance brought down	483			

GOODS SENT ON CONSIGNMENT ACCOUNT

19..		£	19..		£
May 31	To Trading Account ..	400	Mar. 1	By Consignment Account – Ore	400
		£400			£400

Note

The balance carried down in the Consignment Account is made up as follows:

			£
80 tons of Ore @ 45s. per ton (current market value)			180
Railway Freight		£140	
B. Jones & Co.'s charges on whole consignment		465	
	$\frac{80}{159 \cdot 5} \times$	£605	303
			£483

The stock on consignment is treated as an asset at the balancing date. The cost price of the whole of the goods sent out on consignment is eliminated from the Trading Account by the transfer from Goods on Consignment Account.

Where the consignee is authorised to sell goods on credit, and at the date of the Account Sales there is an amount outstanding in respect of credit sales, that amount can be recorded as a balance carried down on the Consignment Account, or by crediting Consignment Account and debiting Consignment Debtors Account. When an Account Sales is subsequently received, showing the receipt of the cash from the debtors, the amount will be transferred to the debit of the Consignee's Personal Account. A consignee, other than a *del credere* agent, should not be debited with the proceeds of sale until he has received them in cash.

Illustration (3)

On 1st April, Emen & Co. had consigned to C. Onsignee, goods costing £4,000, on which they paid freight, insurance, etc., amounting to £500. On 31st August, C. Onsignee's first Account Sales was received, showing that he had effected sales of £2,800, of which £2,500 had been received in cash. His expenses to date were £400, and Commission, 5% on gross sales. On receipt of the Account Sales, the Consignment Account was balanced off, stock being valued at £3,000. A further Account Sales was received on 31st December, shewing that the balance of the goods had been sold for £3,450 and the cash collected: debtors had also paid, less a discount of 5%. The expenses of C. Onsignee were £120, commission 5%. Write up the accounts in the books of Emen & Co. to 31st December, assuming C. Onsignee remitted the balance due with each Account Sales.

CONSIGNMENT ACCOUNT

19..		£	19..		£
April 1	To Goods sent on Consignment ..	4,000	Aug. 31	By C. Onsignee –	
	„ Freight, Insurance, etc.	500		Cash Collected *re* Sales	2,500
Aug. 31	„ C. Onsignee –			„ Sales on Credit c/d.	300
	Expenses	400		„ Stock c/d.	3,000
	Commission on gross sales at 5% ..	140			
	„ Profit and Loss Account	760			
		£5,800			£5,800
19..			19..		
Aug. 31	To Balances b/d. –		Dec. 31	By C. Onsignee –	
	Debtors	300		Cash Collected *re* Sales	3,450
	Stock	3,000		From Debtors	285
Dec. 31	„ C. Onsignee –				
	Expenses	120			
	Commission	173			
	„ Profit and Loss Account	142			
		£3,735			

C. ONSIGNEE

19..		£	19..		£
Aug. 31	To Consignment Account – Cash Collected ..	2,500	Aug. 31	By Consignment Account – Expenses ..	400
				Commission ..	140
				„ Cash	1,960
		£2,500			£2,500
19..			19..		
Dec. 31	To Consignment Account – Cash Collected ..	3,735	Dec. 31	By Consignment Account – Expenses .	120
				Commission ..	173
				„ Cash . ..	3,442
		£3,735			£3,735

Note
The discount is automatically recorded by bringing into account only the cash collected. There is no point in shewing it as a debit and a credit in the Consignment Account.

GOODS SENT ON CONSIGNMENT ACCOUNT

19..		£	19..		£
Aug. 31	To Trading Account ..	4,000	Apl. 1	By Consignment Account	4,000

Where some of the goods are damaged or lost in transit, the loss, if not excessive, may be charged to the Consignment Account automatically by crediting that account only with the reduced value of the stock remaining on hand at the date of balancing the accounts. If it is desired to record the loss separately, the cost price of the damaged goods can be entered on both sides of the account. Goods lost before they reach the consignees, however, should be credited to the Consignment Account and debited to Profit and Loss Account at cost less any amounts recovered from underwriters. Any goods returned to the consignor will be credited to the Consignment Account and debited to the Goods sent on Consignment Account at cost.

Where the agent is authorised to give goods away for advertising purposes, the cost thereof (including the expenses incurred in connection therewith) should be credited to Consignment Account and debited to Advertising Account, which latter account would in due course be transferred to the debit of Profit and Loss Account. Alternatively, if it is desired that the cost of advertising shall be borne by the consignment, the cost of the goods distributed should be both credited and debited to the Consignment Account, the balance of which will then represent the net profit or loss on the consignment, after all expenses incurred in selling the goods have been deducted.

It is not uncommon for the goods to be invoiced to the consignee at a *pro forma* price in excess of cost, in which case columns should be provided in the Consignment Account for recording the price alongside the ordinary entries. The invoice columns are purely memorandum columns for the purpose of reconciling the invoice price of sales and unsold stock with that of the goods consigned. Entries in the invoice columns form no part of the double entry.

Illustration (4)

A, in London, consigns goods to B in Australia, for sale at invoice price or over. B is entitled to a commission of 5% on invoice prices and 25% of any surplus prices realised. A draws on B at 90 days sight for 80% of the invoice price, and, upon sale, B remits the balance of proceeds, after deducting his commission, by sight draft.

Goods consigned by A to B in the year cost A £10,450, including freight and were invoiced at £14,200. Sales made by B were £13,380, and goods in his hands, unsold at 31st December, represented an invoice value of £3,460 (original cost, including freight £2,610). Sight drafts actually received by A from B up to 31st December, were £3,140; others were in transit.

Prepare accounts in A's books of these transactions and show (by ledger accounts) the manner in which the books would be closed at 31st December.

CONSIGNMENT TO B. (AUSTRALIA) ACCOUNT

	Invoice Price £	£		Invoice Price £	£
To Goods ..	14,200	10,450	By Sales	10,740	13,380
„ B. Commission:			„ Stock c/d.	3,460	2,610
5% on £10,740		537			
25% on £2,640		660			
„ Profit and Loss Account		4,343			
	£14,200	£15,990		£14,200	£15,990
To Balance b/d.	3,460	2,610			

B.

	£		£
To Sales ..	13,380	By Bills Receivable	11,360
„ Balance c/d.	2,317	„ Commission	1,197
		„ Cash ..	3,140
	£15,697		£15,697
		By Balance b/d.	2,317

Note

No account can be taken of drafts in transit, which amount to £451.

GOODS SENT ON CONSIGNMENT ACCOUNT

	£		Invoice Price	£
To Trading Account	10,450	By B.	£14,200	10,450

Note

Apparently the arrangement is that on sale of the goods, B shall remit the proceeds, *less* commission and *less* the proportion of the bill of exchange applicable to the goods sold, *i.e.*, he owes A. on 31st December:

	£
Proceeds of Sale	13,380
Less Commission	1,197
	12,183
Less Proportion of Bill applicable to goods sold, 80% of Invoice Price, £10,740 = ...	8,592
Amount due ..	3,591
He has already remitted	3,140
∴ Drafts in transit amount to	£451

		£
The balance to B's credit is made up of –		
Proportion of Bill applicable to goods in Stock, 80% of Invoice Price, £3,460 =		2,768
Less Drafts in transit		451
Balance	..	£2,317

Where the goods are consigned to an agent abroad whose accounts are rendered in a foreign currency it will be necessary to provide memorandum currency columns in the consignee's personal account, in which the relevant items will be converted into sterling at appropriate rates. As a general rule it will be found convenient to convert sales made by the agent and the agent's expenses and commission at the average rate for the period. Remittances received from the agent should be converted at the actual sums realised, whilst the closing balance of the agent's account should be converted at the rate of exchange prevailing at the date of the Balance Sheet. The resultant sterling balance on the agent's account will represent profit or loss on exchange. This may, if desired, be transferred to the Consignment Account, which will then show the final profit or loss in sterling realised on the consignment. Alternatively, the amount may be transferred to a Difference on Exchange Account which, if in debit, should be written off to Profit and Loss Account, or, if in credit, carried forward as a provision against future possible losses on exchange.

Illustration (5)

On 2nd January, B bought for cash 200 machines at £33 each f.o.b. London for shipment to his Agent G in Berne, to sell on a consignment basis. On 2nd February, B paid £500 for freight and £140 for insurance.

G. sent B an Account Sales dated 31st May showing that he had sold 100 machines at Fr. 550 each and a further 40 machines at Fr. 570 each. G had paid landing charges Fr. 2,750 and selling expenses on the machines sold Fr. 700. His commission was at the rate of Fr. 20 per machine sold, plus one-quarter of the amount by which the gross sale proceeds, less the total commission thereon, exceeded a sum calculated at the rate of Fr. 500 per machine sold. A bank draft dated 31st May was enclosed for the balance due to B, which realised £5,600.

Prepare Consignment Account and G's personal account in B's books as at 30th June, no further machines having been sold by that date.

Sales, expenses and commission are to be converted at the average rate of Fr. 12·5 to £.

CONSIGNMENT TO G. ACCOUNT

Jan. 2	To Goods sent on Consignment: 200 Machines at £33 each		6,600	May 31	By Sale of 140 Machines as per Account Sales (*Fr.* 77,800) ..			6,224
Feb. 2	„ Freight ..		500		„ Stock on hand:			
	„ Insurance ..		140		60 Machines at £33 ..		1,980	
Mar. 31	„ General Expenses as per Account Sales:				Proportion of:			
	Landing Charges ..	220			Freight	£500		
	Selling Expenses ..	56			Insurance ..	140		
	Commission ..	304			Landing Charges	220		
			580		$\frac{60}{200}$ ×	£860		
June 30	„ Loss on Exchange ..		44				258	
	„ Profit and Loss Account – Profit on Consignment		598					2,238
			£8,462					£8,462
June 1	„ Stock on hand b/d.		2,238					

G - PERSONAL ACCOUNT

		Francs	£			Francs	£
May 31	To Consignment Account, Sales:			May 31	By Consignment Account:		
	100 Machines @ *Fr.* 550 .	55,000	4,400		Landing Charges	2,750	220
	40 „ *Fr.* 570 .	22,800	1,824		Selling Expenses ..	700	56
					Commission ..	3,800	304
				June 29	„ Bank Draft ..	70,550	5,600
					„ Consignment Account: Loss on Exchange		44
	Fr.	77,800	£6,224		*Fr.*	77,800	£6,224

Note. Total Commission *Fr.* 2,800 + ½ (77,800 — *x* — 70,000) = *Fr.* 3,800.

§ 4. Entries in the Consignee's Books

When the goods are received by the consignee, particulars thereof should be entered in a consignment stock book ruled for marks and quantities, according to the nature of the goods, and having a column for *pro forma* invoice prices. This book, however, is merely a memorandum book, and no entries should be made in the financial books until a sale takes place. The goods, not being the property of the consignee, must be kept entirely distinct from his own stock, and should not be included in his Balance Sheet.

The entries in the consignee's books will be as follows:

(1) Debit the Consignor's Account with any expenses incurred in connection with the consignment by the consignee, such as freight, warehousing, etc., crediting cash or the relevant personal account.

(2) When sales are made, debit the various debtors' accounts with the amounts thereof and credit the Consignor's Account through a consignment sales day book, or, where there are few transactions, through the ordinary journal.

(3) When the Account Sales is prepared, debit the Consignor's Account with the brokerage, commission, etc., crediting the latter accounts. If any debtors have not yet paid their accounts carry forward a balance to the credit of the Consignor's Account in respect thereof, unless by the terms of the agency, the agent has to remit in full.

(4) The balance of the Consignor's Account will represent the amount due to him. If a draft is remitted, debit his account and credit Bills Payable or cash, as the case may be, so closing the account.

Illustration

From the particulars given in the Illustration (1) (page 96) make the entries in the consignee's books.

CONSIGNEE'S BOOKS

THE A. MINING COMPANY LIMITED

		£	19..		£
July	To Ocean Freight	360	July 1	By Sundry Debtors	1,276
	„ Dock Dues	90			
	„ Marine Insurance	15			
	„ Brokerage	16			
	„ Commission	32			
	„ Bills Payable	763			
		£1,276			£1,276

Detailed particulars will also be entered in the consignment stock book by way of memoranda as described above.

An alternative method for recording consignments in the consignee's financial books, is to debit a Consignment Stock Account and credit the Consignor's Account with the invoice value of the goods. When the goods are sold, the proceeds are credited to the Consignment Stock Account, and the difference on this account, representing profit, is then transferred to the Consignor's Account. The Consignment Stock Account and the corresponding credits to the consignor's Account, must, of course, be eliminated from the consignee's Balance Sheet. It might be considered preferable to credit a Consignor's Suspense Account with the invoice value, in order to preclude the possibility of a payment inadvertently being made to the consignor before the goods are sold.

This method is not to be recommended, as it takes into the consignee's financial books as assets and liabilities items which are not such from his point of view.

§ 5. Accounts with Agents

In many cases, where agencies are situated in different parts of the world, it is not convenient to treat the goods sent to such agents as consignments, and often, even in cases of consignments proper, it is not desired to show the profit or loss on each shipment. In such cases Consignment Accounts, as illustrated in § 3 are not used, but the transactions may be dealt with in the manner described hereunder.

Memorandum quantity stock accounts are kept, showing particulars of goods sent to the agent. No entries are made, otherwise than by way of memoranda, when goods are sent to the agent, except that the proper nominal accounts are debited with any expenses incurred. When the agent's returns are received, Sales Account is credited with the gross sales and the Agent's Account debited. Any expenses incurred by the agent are credited to his account, and debited to the appropriate expense accounts. The Agent's Account is credited with sums remitted by him, and the balance on his account at any time will be the amount due by him for sales effected. In this way the agent will not be debited with the value of any stock unsold, as this will be regarded as stock belonging to the firm and brought into the Balance Sheet at cost plus expenses, or at a lower valuation if necessary.

The agent will forward at regular intervals quantity stock accounts, which will be agreed with the similar accounts kept at the head office, any differences in stock being adjusted.

Illustration (1)

The X Manufacturing Company forwarded goods to the value of £3,400 to their agent, incurring the following expenses:

		£
Carriage and Freight	..	140
Insurance ..	.. ..	15

Up to the date of balancing the accounts the agent had forwarded returns showing the following transactions:

	£
Cash Sales	1,250
Credit Sales	1,575
Cash collected from Debtors	1,300
Sundry expenses	130
Cash remitted	2,400
Stock on hand at cost ..	1,340

Show by Journal entries how these transactions should be recorded in the books of the X Manufacturing Company, and prepare the agent's Personal Account.

X MANUFACTURING COMPANY

JOURNAL

			£
Sundries	*Dr.*		
To Cash			155
Carriage and Freight Account		140	
Insurance Account		15	
Being expenses incurred in dispatch of goods to agent.			
Agent's Account	*Dr.*	2,825	
To Sundries –			
Cash Sales Account ..			1,250
Credit Sales Account ..			1,575
Being sales effected as per agent's returns.			
Sundry Expenses Account	*Dr.*	130	
To Agent's Account			130
Being agent's expenses as per his returns.			
Cash		2,400	
To Agent's Account ..			2,400
Being cash remitted by agent.			

AGENT'S PERSONAL ACCOUNT

	£		£
To Sales Account	2,825	By Expenses Account	130
		„ Cash ..	2,400
		„ Balance c/d. ..	295
	£2,825		£2,825
To Balance b/d. ..	295		

NOTE. The memorandum Stock Account will be debited with £3,400 stock sent, and credited with the cost value of sales. The balance should represent the value of stock in agent's hands and will be included in the company's stock when the Trading Account and Balance Sheet are prepared.

Although not recommended, the agent's account is sometimes debited with the cost of the goods sent to him, but care must be taken, if goods are debited at more than cost, to reduce the value of stock in his hands at balancing time to cost price, so that no credit is taken for profit before it is actually realised.

Where the agent is so debited, it is advisable to create a provision of an equal amount. This can readily be done in the following way:

(1) Debit the Agent's Account and credit a 'Goods sent to Agents Account' with the invoice price.

(2) When sales are notified (*a*) debit Goods sent to Agents Account and credit Sales Account with the amount of the sales; (*b*) debit the Agent's Account and credit

Goods sent to Agents Account with the excess of the selling over invoice price of the goods sold; and (*c*) debit the various expense accounts and credit Agent's Account with the expenses paid by him.

(3) Debit cash and credit the Agent's Account with remittances received from the agent.

(4) For the purposes of the Balance Sheet and Profit and Loss Account, the Goods sent to Agents Account will be deducted from the balance on the Agent's Account so that the latter will show only the amount, if any, due from him. Stock will be valued as usual, and included in the accounts as stock in the hands of agents, by debiting a Stock Account and crediting Trading Account. This Stock Account will be closed in due course by transfer to the next period's Trading Account.

Illustration (2)

Goods costing £1,000 were invoiced to an agent at £1,200. In due course the agent submitted a return showing that he had sold three-fourths of the goods for £1,500, paying expenses amounting to £50, and enclosing a draft for £1,100. The Stock was valued at £240, prices having fallen.

Write up the accounts affected.

AGENT'S ACCOUNT

To Goods at invoice price	1,200	By Expenses Account ..	50
" do. excess of selling price over invoice price	600	" Cash	1,100
		" Balance c/d. ..	650
	£1,800		£1,800
To Balance b/d.	650		

GOODS SENT TO AGENTS ACCOUNT

			£
To Sales Account	1,500	Agent's Account	1,200
" Balance c/d.	300	" " " excess of selling price over invoice price	600
	£1,800		£1,800
		By Balance b/d.	300

SALES ACCOUNT

			£
To Trading Account	1,500	By Goods sent to Agents Account	1,500

TRADING ACCOUNT

			£
		By Sales Account ..	1,500
		" Stocks in hands of Agent	240

EXPENSES ACCOUNT

	£		
To Agent's Account ..	50		

STOCK IN HANDS OF AGENTS ACCOUNT

	£
To Trading Account ..	240

The Balance Sheet will include £350 as due from the agent, *viz.*, the balance of his account, £650, less the provision on Goods sent to Agents Account, £300. This amount is made up of the following:

		£	£
Proceeds of sale of goods	..		1,500
Less Expenses ..	..	50	
Cash remitted	..	1,100	
		——	1,150
			£350

Where foreign agents are concerned, it may be necessary to record the transactions in currency, in which case currency as well as sterling columns must be utilised, and any difference on exchange dealt with as explained in Chapter X, § 7.

CHAPTER VI

BILLS OF EXCHANGE, PROMISSORY NOTES, ETC.

§ 1. Definitions

(a) Bill of Exchange

A *Bill of Exchange* is defined by the Bills of Exchange Act, 1882, as 'an unconditional ORDER in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of, a specified person or to bearer'.

There are three parties to a bill, *viz.* – (1) the *drawer*, *i.e.*, the party who draws the bill in the first instance and signs it; (2) the *drawee*, *i.e.*, the party to whom the bill is addressed; and (3) the *payee*, *i.e.*, the party to whom the bill is payable. The drawer is the creditor, the drawee the debtor, and the payee may be the drawer himself or some other person to whom the drawer owes money.

A drawee 'accepts' a bill, by signing his name across the face of it, and thereby becomes the *acceptor*. Until the drawee becomes the acceptor he is not liable on the bill. When the bill is negotiated (*i.e.*, transferred from one person to another in such a manner as to constitute the transferee the holder of the bill), each party through whose hands it passes must indorse his name on the back thereof, and thereby becomes an *indorser*, unless the bill is drawn to bearer, when it requires no indorsement but is negotiated by delivery only. If a bill payable to order is indorsed in blank in the first instance it thereby becomes a bearer bill and no further indorsement is legally necessary.

A cheque is the most common form of bill of exchange, being defined by the Bills of Exchange Act, 1882, as 'a bill of exchange drawn on a banker, payable on demand'.

(b) Promissory Note

A *Promissory Note* is an unconditional PROMISE in writing made by one person to another, signed by the maker, engaging to pay on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer.

The parties to a promissory note are: (1) the *promisor*, *i.e.*, the party who makes the promise and signs the note; and (2) the *promisee*, *i.e.*, the party to whom the promise is made. There may be a single promisor, or two or more promisors. In the latter case the liability of the promisors may be either *joint*, or *joint and several*. If the liability is joint, any judgment without satisfaction against one of the makers of the note is a bar to proceedings against the other joint maker or makers. This is not the case if the note is joint and several, since an unsatisfied judgment against one can be followed by action against another party.

When a promissory note payable to order is negotiated, each party through whose hands it passes must indorse his name on the back thereof, and thereupon becomes an *indorser*.

A Bank of England Note is the most common form of promissory note. This, however, is payable to bearer, and requires no indorsement.

(c) Negotiable Instruments

Negotiable Instruments are documents representing value in money, such as promissory notes, bills of exchange, etc., the property in which passes by mere delivery, or by indorsement and delivery.

As a general rule a party cannot give a better title to property than he himself possesses, but in the case of a negotiable instrument, provided the holder receives it in good faith for valuable consideration, before it is overdue, and without notice of any prior defect in the title, his title will be good, notwithstanding any defect in the title of any prior holder.

(d) Days of Grace

Three days, termed 'the days of grace', are allowed as an addition to the stated term or 'tenor' for the payment of all bills of exchange and promissory notes, except those payable at sight or on demand, or expressed to be payable at a fixed date without days of grace, or for a period *certain*. In calculating the due date, therefore, allowance must be made for the three days of grace. Similarly, three days of grace must be taken into account in calculating interest or discount.

Where a bill is so drawn that the third day of grace falls on a Sunday, Good Friday, Christmas Day, or other day of public thanksgiving, the bill must be paid upon the *preceding* business day. If the third day of grace is a bank holiday the bill is payable on the *succeeding* business day. If the third day of grace falls on a Sunday and the previous day is a bank holiday, the bill is payable on the *succeeding* business day.

Illustration

If the third day of grace falls on Sunday 14th November, the bill is payable on Saturday 13th November.

If the third day of grace falls on Sunday 26th December, since the previous day is Christmas Day, the bill is payable on 24th December.

If the third day of grace is Sunday 27th December, since the previous day is a bank holiday, the bill is payable on Monday 28th December.

When the tenor of a bill of exchange is expressed in months the due date is calculated by adding three days to the day of the last month of the tenor which corresponds with the day of the month on which the bill is drawn. Thus by the custom of bankers, a bill of one month drawn on 28th February would fall due on 31st March *i.e.* three days after 28th March, not three days after 31st March. No account is, however, taken of missing days, so that if a bill at one month were drawn on 31st January in a year other than a leap year, it would fall due on 3rd March, *i.e.* three days after 28th February.

§ 2. Stamp Duties on Bills of Exchange and Promissory Notes

	s.	d.
Bill of exchange payable on demand, at sight, on presentation, or within three days after date or sight	–	2

(This stamp may be adhesive.)

	s.	d.
Bill of exchange drawn and expressed to be payable out of the United Kingdom, when actually paid or indorsed or in any manner negotiated in the United Kingdom:		
Where the amount exceeds £50 and does not exceed £100	–	6
Where the amount exceeds £100, for every £100 or fractional part of £100	–	6
Where the amount does not exceed £50, the stamp duty thereon is the same as for inland bills.		
Bill of exchange of any kind whatsoever, and promissory note of any kind whatsoever (except a bank note), drawn and expressed to be payable, or actually paid or indorsed, or in any manner negotiated, in the United Kingdom (except as above):		
Where the amount or value of money for which the bill or note is drawn or made does not exceed £10	–	2
exceeds £10 and does not exceed £25	–	3
,, £25 ,, ,, ,, ,, £50	–	6
,, £50 ,, ,, ,, ,, £75	–	9
,, £75 ,, ,, ,, ,, £100	1	0
exceeding £100, for every £100 and fraction of £100	1	0

§ 3. Specimen Forms of Bills of Exchange and Promissory Notes

The following are specimen forms of bills of exchange:

I.

London, 1st February 19..

£100 Three months after date pay to my order the sum of One hundred pounds sterling for value received.

Stamp
1s.

To Messrs. BLACK & CO., F. SMITH.
Glasgow.

In this case the drawer and the payee are one and the same person, *viz.*, F. Smith. Black & Co. are the drawees, who, on accepting the bill, become the acceptors.

II.

London, 1st February 19..

£436 Three months after date pay to F. Blackmore or order the sum of Four hundred and thirty-six pounds for value received.

Stamp
5s.

To Messrs. A. WHITE & CO., B. WILLIAMS.
London.

In this case the drawer and payee are not the same person.

III.

£1,000 London, 1st February 19..

On demand pay to A. Wilkins or order the sum of One thousand pounds for value received.

Stamp 2d.

To Messrs. A. Black & Co., York. A. Roberts.

In this case the stamp is only 2d., as the bill is payable on demand. The drawer and the payee are again distinct parties.

IV.

£5,000 Calcutta, 1st February 19..

Three months after sight of this first exchange (second and third of even tenor and date unpaid) pay to the order of Mr John Jones the sum of Five thousand pounds for value received.

Stamp £2 10s.

To Messrs. F. Wilkinson & Co., London. R. Phillips & Co.

This is a form of foreign bill drawn in Calcutta payable in this country, and consequently the stamp duty is the ordinary 1s. per cent. Foreign bills are often drawn in duplicate or in sets of three, each part of the set being numbered, and referring to the other parts. The first part coming to hand will be presented for acceptance, and the others destroyed as and when received.

V.

\$1,750 Bombay, 1st February 19..

Two months after sight of this our second of exchange (first and third of even tenor and date unpaid) pay to the order of Mr F. Brown the sum of One thousand, seven hundred and fifty dollars for value received.

Stamp 3s. 6d.

To John L. Smith, New York. F. Wall & Co.

Note. - The rate of exchange has been taken at \$2.80 to the £.

This is an illustration of a bill which is drawn abroad and payable abroad, but it is assumed to have been negotiated in this country. Thus the stamp duty is at the rate of 6d. per cent., the conversion being made as at the date of negotiation in this country. The bill would also have to be stamped according to the law of the country in which it is drawn.

The following are some forms of promissory notes:

I.

£50 London, 1st February 19..

Three months after date I promise to pay A. White & Co. or order the sum of Fifty pounds for value received.

Stamp 6d.

John Lake.

It will be observed that there are only two parties to a promissory note – the promisor and the payee.

II.

£1,000 — London, 1st February 19..

Stamp 10s.

On demand we promise to pay to Messrs. F. White & Co. the sum of One thousand pounds for value received.

C. D.
E. F.

This is an instance of a *joint promissory note*. The promisors are jointly liable, *i.e.*, only one action can be brought, and if action is taken and judgment obtained against one of the parties only, and that judgment is unsatisfied, another action cannot subsequently be brought against the other party.

If the note had been worded 'I promise to pay', and had been signed by both parties as above, the liability would have been joint and several.

It will be observed that all promissory notes, whether on demand or otherwise, bear an *ad valorem* stamp duty.

III.

London, 1st February 19..

£530

Stamp 6s.

Three months after date we jointly and severally promise to pay to the order of Messrs. F. Wilkins & Co. the sum of Five hundred and thirty pounds for value received.

F. T.
W. X.
Y. Z.

This is an instance of a *joint and several promissory note* where the parties are jointly and severally liable, and, in the event of any one of the parties not contributing his proportion, the holder will have a right of recovery for the full amount of the note against any one of the promisors, who in his turn will have a right of recovery from the remaining promisors of their respective contributions.

§ 4. Forms of Bill Books

Bill books are subsidiary books for recording the history of all bills of exchange handled by the business, and serving the purpose of day books, from which the bills are posted in detail to the personal accounts affected, and in total to the Bills Accounts in the ledger.

(a) Bills Receivable and Bills Payable Books

The forms of bill books vary considerably in practice, according to the circumstances of the business and the class of bills dealt with. The essential point is that the bill book should record a concise history of each bill.

The following is a convenient form of bills receivable book which can be adapted to the majority of cases:

Illustration (1)

BILLS RECEIVABLE BOOK

No. of Bill	Date received	From whom received	Drawer	Acceptor	Where Payable	Date of Bill	Term	Date due, including Days of Grace	Folio in Ledger	Amount of Bill	How Disposed of
	19..					19..		19..		£ s. d.	
1	2nd July	H. Marshall	Self	H. Marshall	London	1st July	1 month	4th Aug		50 0 0	Cash received 4th Aug.
2	1st Aug.	J. Wilson	Self	J. Wilson	Lloyds Bank, Ltd.	31st July	50 days	22nd Sept.	5	70 0 0	Dishonoured 22nd Sept.
3	9th Sept.	F. Johnson	F Johnson	L. Taylor	Barclays Bank, Ltd.	3rd Sept.	3 months	6th Dec.	6	90 0 0	Discounted 12th Sept.
										£210 0 0	
										Fo. L.1.	

Each item in the bills receivable book is posted to the credit of the ledger account of the person from whom the bill is received; periodically the total of the bills is posted to the debit of Bills Receivable Account.

The following is a convenient form of bills payable book:

Illustration (2)

BILLS PAYABLE BOOK

No. of Bill	Date given	To whom given	Drawer	Payee	Where Payable	Date of Bill	Term	Date due, including Days of Grace	Folio Ledger	Amount of Bill	How Disposed of
	19..					19		19		£ s. d.	
	15th July	W. Black	W. Black	W. Black	Lloyds Bank Ltd.	14th July	60 days	15th Sept.	7	90 0 0	Paid 15th Sept.
	19th July	F. White	F. White	F. White		18th July	3 months	21st Oct.		80 0 0	
	3rd Aug.	H. Brown	H. Brown	H. Brown		2nd Aug.	2 months	5th Oct.		40 0 0	

Each item in a bills payable book is posted to the debit of the ledger account of the person to whom the bill is given, the total being posted periodically to the credit of Bills Payable Account.

In order to obtain cash before the due date of a bill receivable, the holder may discount it with his banker, *i.e.*, negotiate it to the banker for an immediate cash payment. The banker charges interest on the face value of the bill for the period it still has to run, and pays the balance as its present cash value. This interest is called the 'discount'. It is usual to debit the cash book with the face value of the bill and show the discount as a payment, which will be posted to a Discounting Charges Account.

(b) Bills Receivable and Bills Payable Ledgers

These books are ruled in a similar way to ordinary bill books, but are provided with additional money columns to show the disposal of the bills.

They may be made to form part of the double entry, in which case it will not be necessary to have ledger accounts for bills receivable and bills payable.

The great advantage of this form of book is that a complete history of each bill is recorded in a manner capable of arithmetical proof.

The follo ng is a vable ledge

Illustration

Dr. BILLS RECEIVABLE LEDGER *Cr.*

No. of Bill	Date received	From whom received	Drawer	Acceptor	Where Payable	Date of Bill	Term	Date due, including Days of Grace	Folio in Ledger	Discount payable	Amount of Bill	How Disposed of					
												Date	Fo.	Amount received	Dis-counting Expenses	Total	Remarks

Note to Illustration.

The discount payable column provided in the above form is useful in cases where cash discount is allowed on receipt of an acceptance in the same way as if payment had been made in cash. The detail of each money column on the debit side of this ledger will be posted to the credit of the personal account, the total of the discount payable column being posted to the debit of Discount Payable Account. As already stated, this discount payable must not be confused with the discounting charges on the bill itself.

(c) Bill Diary

Where bill transactions are numerous, it is advisable for all bills, whether receivable or payable, to be entered in special bill diaries, so that the amounts due to be received or paid on any given day can readily be ascertained.

The diaries will be ruled to meet the requirements of the case, a separate space being allotted for each day in the year. The bills are entered under the dates on which they fall due, allowance being made for the three days of grace.

(d) Discounted Bills

The process of discounting a bill is tantamount to selling the bill for its present worth, subject to its being met at maturity, the holder thus obtaining the use of the money before the bill falls due.

The consideration for so obtaining the money in advance is termed 'discount', and is based, in the case of good bills, upon the rates ruling at the date of discounting. This discount has no connection with cash discount or trade discount, and must not be confused therewith, as it is more in the nature of interest.

The entries in the books on discounting a bill are to debit the cash book and credit Bills Receivable Account with the face value of the discounted bill. If the holder's own banker discounts the bill for him, the banker will credit him with the face value of the bill and debit him with the discounting charge, and the entry in the trader's cash book will be made on that basis. Should the holder sell the bill to another bank or to a bill broker, he will receive a cheque for the net amount. He may then debit his cash book with that amount, which will be posted to the credit of Bills Receivable Account, and make a journal entry on the same day, debiting Discounting Charges Account and crediting Bills Receivable Account with the discount charged by the buyer of the bill; or he may record it as explained in the first case above mentioned. The latter treatment is recommended.

A contingent liability remains on a discounted bill until it matures and is met, since, if such a bill is dishonoured, the holder has a right of recourse against the drawer and all previous indorsers. A note should be made on the Balance Sheet of the amount of the contingent liability on discounted bills which have not yet matured, except where it is anticipated that a definite liability will materialise, when specific provision therefor should be made in the accounts.

Illustration

In the books of T. Atkinson, the following debit balances appear on 1st July 19..:

	£
H. Marshall	50
J. Wilson	70
F. Johnson	90

Also the following credit balances:

	£
W. Black	90
F. White	80
H. Brown	40

Enter these balances in the Ledger, and from the particulars given in the Bills Receivable and Bills Payable books illustrated on page 112, make the necessary entries in T. Atkinson's books.

CASH BOOK

19..		Fo.	£ s. d.	19..		Fo.	£ s. d.
Aug. 4	To Bills Receivable ..	1	50 0 0	Sept. 12	By Discount .	3	1 1 0
Sept. 12	" " " ..	1	90 0 0	" 15	" Bills Payable .	2	90 0 0
				" 22	" Noting Charges – J. Wilson's Dishonoured Bill .		5 0

LEDGER

BILLS RECEIVABLE ACCOUNT

19..		Fo.	£ s. d.	19..		Fo.	£ s. d.
Sept. 30	To Sundries .	B.R.B. 1	210 0 0	Aug. 4	By Cash	C.B. 1	50 0 0
				Sept. 12	" Cash	C.B. 1	90 0 0
				" 22	" J. Wilson – Dishonoured Bill	J. 1	70 0 0

BILLS PAYABLE ACCOUNT

19..		Fo.	£ s. d.	19..		Fo.	£ s. d.
Sept. 15	To Cash	C.B. 1	90 0 0	Sept. 30	By Sundries ..	B.P.B. 1	210 0 0

DISCOUNTING CHARGES ACCOUNT

19..		Fo.	£ s. d.
Sept. 12	To Sundries	C.B. 1	1 1 0

H. MARSHALL

		Fo.	£ s. d.	19..		Fo.	£ s. d.
July 1	To Balance brought for-forward ..		50 0 0	July 2	By Bill Receivable	B.R.B. 1	50 0 0

J. WILSON

19..		Fo.	£ s. d.	19..		Fo.	£ s. d.
July 1	To Balance brought forward		70 0 0	Aug. 1	By Bill Receivable	B.R B. 1	70 0 0
Sept. 22	" Bills Receivable Account – Dishonoured Bill ..	J. 1	70 0 0				
	" Noting Charges ..	C.B. 1	5 0				

F. JOHNSON

19..			£ s. d.	19..		Fo.	£ s. d.
July 1	To Balance brought forward		90 0 0	Sept. 9	By Bill Receivable	B.R.B. 1	90 0 0

W. BLACK

19..		Fo.	£ s. d.	19.			£ s. d.
July 15	To Bill Payable	B.P.B. 1	90 0 0	July 1	By Balance brought forward		90 0 0

F. WHITE

19..		Fo.	£ s. d.	19..			£ s. d.
July 19	To Bills Payable	B.P.B. 1	80 0 0	July 1	By Balance brought forward		80 0 0

H. BROWN

19..			Fo.	£	s.	d.	19..				£	s.	d.
Aug.	3	To Bill Payable	B.P.B. 1	40	0	0	July	1	By Balance brought forward		40	0	0

(e) Advances on the Security of Bills

Sometimes arrangements may be made with the banker for the bills to be deposited with him, and an advance of a proportion of the amount to be made against them.

In these cases, the bills are not discounted, but remain the property of the trader, who deposits them with the bank as security for the advance. In effect, he pledges them with the banker. In the trader's books the bills will accordingly remain as assets in the Bills Receivable Account, an Advances on Bills Account being credited and cash debited with the amounts of the advances received.

When a bill matures, the banker will collect the proceeds and account to the trader for the excess of the amount received over the sum advanced plus the interest charged. The following entries should be made in the trader's books on receiving notification from the bank that a bill deposited as security has been paid:

(1) Debit Advances on Bills Account and credit Bills Receivable Account with the full amount of the Bill.

(2) Credit Advances on Bills Account and debit Interest on Advances Account with the interest charged by the bank.

(3) Debit Cash and credit Advances on Bills Account with the balance of the proceeds of the bill received from the bank.

If notification is received from the bank that a bill deposited as security has been dishonoured, the trader will have to repay the advances made on the bill by the bank, together with the bank's charge for interest and expenses. He should accordingly debit Advances on Bills Account with the amount of the bill, and Interest Account with the bank interest, crediting cash with the total amount so paid.

Illustration

Amongst the ledger balances of a limited company, carrying on business as shippers, there appeared the following on 31st March:

	£
Bills Receivable	8,620
Export Bank Ltd. Advances on Bills Account	6,535
,, ,, ,, Special Margins Account	816

Note. The Special Margins Account represents amounts deposited with the Export Bank to provide additional security in respect of the bills against which the bank has made advances.

The undermentioned transactions took place:

April 3 Received of Export Bank Ltd. £26 10s. 0d., being balance of proceeds of bill No.308 for £150, a sum of £3 10s. 0d. having been charged for interest on the advance.

,, 12 Advice from Export Bank Ltd. of payment of bill No.320 for £200, which had been advanced against in full. The bank sent a debit note for interest for £4 15s. 0d. and a cheque was sent for this.

April 15 Advice from the company's own bankers of the receipt of £185 being proceeds of bill No.312 for that amount, sent to them for collection.

„ 20 Advice from Export Bank Ltd. that X.Y. of Bombay had refused to take delivery of goods relating to bill No.316 for £125, and that the documents had been handed over to the company's agents. The bank claimed repayment of their advance of £100, plus interest £4 2s. 0d., and a remittance was sent to them accordingly.

Received from A. Y. Co. an acceptance for £200 (bill No.330), against which the Export Bank Ltd. advanced £160.

„ 30 Export Bank Ltd. advised having received £350, being payment in full of bill No.324. They deducted their advance of £280, plus interest £6 5s. 0d., and placed the balance to the credit of the company's Special Margins Account.

May 20 Received from the Bombay agent a remittance for £70, being the net proceeds of the sale by him of the goods originally sold to X. Y. The agent advised that he had lodged with X. Y. a claim for the shortfall, plus an amount of £10 for warehousing the goods prior to the sale as this may have to be paid by the company.

„ 23 Advice from Export Bank Ltd. of the receipt by them of £55, being payment on account, against partial delivery, of bill No.317 for £165, upon which they had made an advance of 80%.

The company's own bankers were the Empire Bank Ltd. All amounts received were paid to the credit of the company's account there and all payments made by cheque.

Shew – by means of ledger accounts – how the foregoing transactions would be entered in the books of the company, and bring down the balances on the various accounts.

BILLS RECEIVABLE ACCOUNT

		£ s. d.			£ s. d.
Mar. 31	To Balance b/f.	8,620 0 0	Apr. 3	By Export Bank Ltd., Bill No.308 ..	150 0 0
Apr. 20	„ A. Y. Co. Bill No.330	200 0 0	„ 12	„ Export Bank Ltd., Bill No.320 ..	200 0 0
			„ 15	„ Cash, Bill No.312	185 0 0
			„ 20	„ X. Y., Bill No.316 .	125 0 0
			„ 30	„ Export Bank Ltd., Bill No.324	350 0 0
			May 31	„ Balance c/d. .. .	7,810 0 0
		£8,820 0 0			£8,820 0 0
June 1	To Balance b/d.	7,810 0 0			

SUSPENSE ACCOUNT – RECEIPT ON ACCOUNT OF BILL NO.317 AGAINST PARTIAL DELIVERY

		£ s. d.			£ s. d.
May 31	To Balance c/d.	55 0 0	May 23	By Export Bank Ltd	55 0 0
			June 1	By Balance b/d.	55 0 0

EXPORT BANK LTD. – ADVANCES ON BILLS ACCOUNT

		s. d.			s. d.
Apr. 3	To Bill No.308..	150 0 0	Mar. 31	By Balance brought forward ..	6,535 0 0
„ 12	„ Bill No.320..	200 0 0	Apr. 3	„ Cash, Bill No.308 . ..	26 10 0
	„ Cash	4 15 0		„ Interest, Bill No.308 ..	3 10 0
„ 20	„ Cash, repayment of advance on Bill No.316	104 2 0	„ 12	„ Interest, Bill No.320	4 15 0
„ 30	„ Bill No.324..	350 0 0	„ 20	„ Interest, Bill No.316 . ..	4 2 0
May 23	„ Bill No.317, payment on account	55 0 0	„ 20	„ Cash, advance against Bill No.330	160 0 0
„ 31	„ Balance c/d.	5,940 0 0	„ 30	„ Interest, Bill No.324	6 5 0
				„ Special Margins Account, Balance *re* Bill No 324 .. .	63 15 0
		£6,803 17 0			£6,803 17 0
			June 1	By Balance b/d.	5,940 0 0

EXPORT BANK LTD. - SPECIAL MARGINS ACCOUNT

		£ s. d.			£ s. d.
Mar. 31	To Balance brought forward	816 0 0	May 31	By Balance c/d.	879 15 0
Apr. 30	" Advances on Bills Account	63 15 0			
		£879 15 0			£879 15 0
June 1	To Balance b/d.	879 15 0			

X.Y.

		£ s. d.			s. d.
Apr. 20	To Bill No.316, not accepted ..	125 0 0	May 20	By Cash – Sale of goods covered by Bill No.316	70 0 0
May 20	" Warehousing Expenses Account Suspense	10 0 0	31	" Balance c/d.	65 0 0
		£135 0 0			£135 0 0
June 1	To Balance b/d.	65 0 0			

INTEREST ACCOUNT

		£ s. d.			£ s. d.
Apr. 3	To Export Bank Ltd.	3 10 0	May 31	By Balance c/d.	18 12 0
" 12	" Export Bank Ltd.	4 15 0			
" 20	" Export Bank Ltd.	4 2 0			
" 30	" Export Bank Ltd.	6 5 0			
		£18 12 0			£18 12 0
June 1	To Balance b/d.	18 12 0			

§ 5. Accommodation Bills

An *Accommodation Bill* is one to which a person has put his name, whether as a drawer, acceptor or indorser, without valuable consideration, for the purpose of accommodating some other party who desires to raise money by negotiating it.

There are three common methods of raising money on accommodation bills:

(1) Where one party, for the convenience of another, accepts a bill without valuable consideration, to enable the drawer to discount the bill and thus raise money, the drawer repaying the acceptor when the bill becomes due.

Illustration (1)

For B's convenience A accepted a bill on 1st January 19.., for £100 at three months.

B discounted the bill forthwith, and paid the proceeds, *viz.*, £98, into his bank.

On the bill falling due A met it and notified B, who had arranged to reimburse A on the due date. B, however, was unable to do this, but arranged to give A immediately a cheque for £50, and a bill at one month for the balance. This bill was duly met at maturity.

Show the entries as they would appear in the books of both A and B, and state at what date the bills fell due.

A's BOOKS

B's ACCOUNT

19..		£	19..		£
Jan. 1	To Bills Payable	100	April 4	By Cash	50
			"	" Bills Receivable	50
		£100			£100

BILLS PAYABLE ACCOUNT

19..		£	19..		£
April 4	To Cash	100	Jan. 1	By B	100

CASH BOOK

19..		£	19..		£
April 4	To B	50	April 4	By Bills Payable	100
May 7	„ Bills Receivable ..	50			
		£100			£100

BILLS RECEIVABLE ACCOUNT

19..		£	19..		£
April 4	To B	50	May 7	By Cash	50

B's BOOKS

A's ACCOUNT

19..			19..		£
April 4	To Cash ..	50	Jan. 1	By Bills Receivable	100
„	„ Bills Payable	50			
		£100			£100

BILLS RECEIVABLE ACCOUNT

19..		£	19..		£
Jan. 1	To A	100	Jan. 1	By Cash	100
		£100			£100

CASH BOOK

19..		£	19..		£
Jan. 1	To Bills Receivable	100	Jan. 1	By Discounting Charges	2
			April 4	„ A	50
			May 7	„ Bills Payable ..	50

DISCOUNTING CHARGES ACCOUNT

19..		£
Jan. 1	To Cash ..	2

BILLS PAYABLE ACCOUNT

19..		£	19..		£
May 7	To Cash ..	50	April 4	By A	50

Note. The first bill fell due on the 4th April, and the second on the 7th May.

(2) Where one person draws a bill on another party, who accepts it, without valuable consideration, for their mutual convenience. The bill is discounted by the drawer, who immediately remits half the proceeds to the acceptor, remitting the cash to meet his half share when the bill becomes due, each party sharing the expenses of discount.

Illustration (2)

For the mutual convenience of A and B, A draws a bill on B for £100 at three months on 1st January 19... B accepts the bill and returns it to A, who discounts it with his bankers on 4th January at 6 per cent., the arrangement being that A and B shall share the proceeds equally.

On the bill falling due A remits his proportion, and the bill is met in due course by B. Show the entries as they would appear in the books of both A and B, making calculations in months.

A's BOOKS

B's ACCOUNT

19..			£ s. d.	19..			£ s. d.
Jan.	4	To Cash	49 5 0	Jan.	1	By Bills Receivable	100 0 0
		" Discount	15 0				
April		" Cash	50 0 0				
			£100 0 0				£100 0 0

BILLS RECEIVABLE ACCOUNT

19..			£ s. d.	19..			£ s. d.
Jan.	1	To B	100 0 0	Jan.	4	By Cash .	100 0 0

CASH BOOK

19..			£ s. d.	19..			£ s. d.
Jan.	4	To Bills Receivable	100 0 0	Jan.	4	By Discounting Charges	1 10 0
				"		" B . ..	49 5 0
				April	4	" B . ..	50 0 0

DISCOUNTING CHARGES ACCOUNT

19..			£ s. d.	19.			£ s. d.
Jan.	4	To Cash ..	1 10 0	Jan.	4	By B	15 0

B's BOOKS

A's ACCOUNT

19..			£ s. d.	19..			£ s. d.
Jan.	1	To Bills Payable	100 0 0	Jan.	4	By Cash ..	49 5 0
				"		" Discounting Charges	15 0
				April	4	" Cash ..	50 0 0
			£100 0 0				£100 0 0

BILLS PAYABLE ACCOUNT

19..			£ s. d.	19..			£ s. d.
April	4	To Cash .	100 0 0	Jan.	1	By A ..	100 0 0

CASH BOOK

19..			£ s. d.	19..			£ s. d.
Jan.	4	To A ..	49 5 0	April	4	By Bills Payable	100 0 0
April	4	" " ..	50 0 0				

DISCOUNTING CHARGES ACCOUNT

19..		£ s. d.
Jan. 4	To A	15 0

Note to Illustration.

When it is stated that a bill is discounted at a certain rate per cent., the addition of the words 'per annum' is usually implied, and the calculation of the discount should be made on the term of the bill. In practice, discount is calculated on the number of days, including days of grace, but in these illustrations it has been calculated in months.

(3) Where two parties each draw a bill of equal amount on the other, and discount the other's bill, meeting their own bills when they fall due, and paying the expenses of discounting each other's bill.

Illustration (3)

On 1st January 19.., A draws a bill on B at four months for £500, and B draws on A for a similar amount and term. Both bills are accepted and discounted respectively at 5 per cent. At maturity A meets his own acceptance, but B's acceptance is dishonoured, with the result that, A, the drawer, is called upon to take it up. The bank charges expenses on the dishonoured bill 6s. 8d. B then accepts a new bill at three months for the amount due by him, plus interest at 5 per cent. per annum, which is duly met at maturity.

Show the entries in the books of both parties, making calculations in months.

A's BOOKS

B's ACCOUNT

19		£ s. d.	19..		£ s. d.
Jan. 1	To Bills Payable	500 0 0	Jan.	By Bills Receivable	500 0 0
May 4	„ Cash: Bill dishonoured and expenses	500	May		506 11 9
	„ Interest . ..	6			
		£1,006 11 9			£1,006 11 9

BILLS RECEIVABLE ACCOUNT

19..		£ s. d.	19 .		£ s. d
Jan. 1	To B	500 0 0	Jan. 1	By Cash	500 0 0
May 4	„ „	506 11 9	Aug. 7		506 11 9
		£1,006 11 9			£1,006 11 9

BILLS PAYABLE ACCOUNT

19..		£ s. d.	19..		£ s. d.
May 4	To Cash	500 0 0	Jan. 1	By B	500 0 0

CASH BOOK

19..		£ s. d.	19..		£ s. d.
Jan. 1	To Bills Receivable	500 0 0	Jan.	By Discounting Charges ..	8 6 8
Aug. 7	„ „ „	506 11 9	May 4	„ Bills Payable	500 0 0
				„ B – Bill dishonoured and expenses	500 6 8

DISCOUNTING CHARGES AND INTEREST ACCOUNT

19 .		£ s. d.	19 .		£ s. d.
Jan. 1	To Cash	8 6 8	May 4	By B ..	6 5 1

B's BOOKS

A's ACCOUNT

		£ s. d.			£ s. d.
19..			19.		
Jan. 1	To Bills Payable	500 0 0	Jan.	By Bill Receivable .	500 0 0
May 4		506 11 9	May	„ Bills Payable .	500 0 0
				„ Interest and Expenses.	6 11 9
		£1,006 11 9			£1,006 11 9

BILLS PAYABLE ACCOUNT

		£ s. d.			£ s. d.
19..			19 .		
May 4	To A – Bill met by him	500 0 0	Jan. 1	By A	500 0 0
Aug. 7	„ Cash ..	506 11 9	May 4	„ A	506 11 9
		£1,006 11 9			£1 006 11 9

BILLS RECEIVABLE ACCOUNT

		£ s. d.			£ s. d
19..			19.		
Jan. 1	To A	500 0 0	Jan.	By Cash	500 0 0

DISCOUNTING CHARGES, INTEREST AND EXPENSES ACCOUNT

		£ s. d.
19..		
Jan. 1	To Cash	8 6 8
May 4	„ A ..	6 11 9

CASH BOOK

		£ s. d.			£ s. d
19..			19..		
Jan. 1	To Bills Receivable	500 0 0	Jan. 1	By Discounting Charges	8 6 8
			Aug. 7	„ Bills Payable	506 11 9

It should be noted that the interest charged is for the period of the *new* bill, *i.e.* for the period for which A has to wait for his money.

§ 6. Dishonoured Bills, Retired Bills, Short Bills, etc.

(a) Dishonoured Bills

When a bill is not met at maturity by the acceptor it is said to be 'dishonoured', and the entry in the books of the drawer will be to credit the Bills Receivable Account and debit the account of the person from whom the bill was received.

If a bill which has been discounted by the holder with a bank is dishonoured at maturity, the holder will be required to meet the bill and pay the expenses incurred by the bank in noting it. He will accordingly credit the cash book with the amounts so paid and debit the account of the person from whom he received the bill. The person who discounted the bill will, of course, bear the discounting charge himself, but the expenses incurred by reason of the dishonour of the bill must be borne by the person who dishonoured it. Any cash discount allowed to such person should also be re-debited to him, as the condition of allowing such discount was that the bill should be honoured at maturity. This discount must not be confused with the expenses of discounting the bill itself.

(b) Retired Bills

Bills may be 'retired' before their due date, either under rebate (*see* (*e*) below) or for 'renewal', as in the following circumstances:

It occasionally happens that a person who has accepted a bill, subsequently discovers that it will be inconvenient or impossible for him to meet it at maturity, and consequently he approaches the drawer of the bill, and endeavours to make arrangements for the withdrawal of the original bill and the substitution of another in its place, thus giving himself additional time wherewith to find the money required. In such cases interest is usually charged by the drawer for the convenience afforded.

In some cases, the drawer may have discounted the bill and may not be aware of the identity of the present holder, or may be reluctant to approach the holder (*e.g.*, his bank), as such a course may tend to damage his own credit. If he wishes to assist the acceptor, he gives him a cheque for the amount of the bill so that it can be met, and draws another bill for an equivalent amount with possibly the addition of interest, for a term to meet the convenience of the acceptor. The drawer would then discount this bill so as to obtain funds to meet the cheque. The charge for interest would compensate him for the discount which he would be called upon to pay in respect of the new bill.

Illustration

(*a*) K. & K. of New York, on 8th June consigned goods of the invoice value of £4,375 to J. & J., of London, drawing by arrangement on the F. T. Bank Ltd., in London, a three months draft for 80% of the invoice value.

(*b*) J. & J., whose bankers are Barclays, drew a cheque on 11th Sept. to meet the draft.

(*c*) In order to finance the transaction, on 10th Sept., J. & J. drew a three month's bill on the F. T. Bank for £3,500, discounting this bill with the F. T. Bank, who held the documents of the consignment as security. The F. T. Bank charged one-half per cent. commission; discount was £49 11s. 6d. The balance was passed by cheque to J. & J., who paid the cheque into their bank.

(*d*) On 13th December, the bill in (*c*) was returned, J. & J. giving a cheque to meet it. J. & J. drew a fresh bill at three months for £4,000 on the F. T. Bank, depositing further security. The bill was discounted by the F. T. Bank, commission being again one-half per cent., discount £49 0s. 11d. The balance was passed by cheque to J. and J., who paid in the cheque to their bankers.

Record the transactions in J. & J.'s ledger.

J. & J.'s LEDGER

K. & K.

19..			£ s. d.	19..			£ s. d.
June	8	To F. T. Bank – Bill at 3 months drawn on F. T. Bank ..	3,500 0 0	June	8	By Goods	4,375 0 0

F. T. BANK

Date	Particulars	£	s.	d.	Date	Particulars	£	s.	d.
19..					19.				
Sept. 10	To Bills Receivable – Bill dated 10th Sept. discounted ..	3,500	0	0	June 8	By K. & K., Bill at 3 months accepted this day	3,500	0	0
„ 11	„ Cash – Discharge of Bill dated 8th June	3,500	0	0	Sept. 10	„ Bills Receivable – Bill at 3 months accepted this day	3,500	0	0
Dec. 13	„ Cash – Discharge of Bill dated 10th Sept. . ..	3,500	0	0		„ Cash for Bill dated 10th Sept. discounted	3,432	18	6
						„ Commission	17	10	0
						„ Discounting charge	49	11	6
Dec 13	To Bills Receivable – Bill dated 13th Dec. discounted	4,000	0	0	Dec. 13	By Bills Receivable, bill at 3 months	4,000	0	0
						„ Cash for bill dated 13th Dec. discounted	3,930	19	1
						„ Commission	20	0	0
						„ Discounting charge	49	0	11

CASH BOOK

Date	Particulars	£	s.	d.	Date	Particulars	£	s.	d.
19..					19..				
Sept. 10	To F. T. Bank – Bill discounted ..	3,432	18	6	Sept. 11	By F. T. Bank – Discharge of Bill dated 8th June	3,500	0	0
Dec. 13	„ F. T. Bank – Bill discounted ..	3,930	19	1	Dec. 13	By F. T. Bank – Discharge of Bill dated 10th Sept. ..	3,500	0	0

BILLS RECEIVABLE ACCOUNT

Date	Particulars	£	s.	d	Date	Particulars	£	s	d
19..					19 .				
Sept. 10	To F. T. Bank – Bill at 3 months..	3,500	0	0	Sept. 10	By F. T. Bank, bill discounted ..	3,500	0	0
Dec. 13	„ F. T. Bank – Bill at 3 months..	4,000	0	0	Dec. 13	„ F. T. Bank, bill discounted ..	4,000	0	0

COMMISSION AND DISCOUNTING CHARGES ACCOUNT

Date	Particulars	s. d.
Sept. 10	To F. T. Bank –	
	Commission	17 10
	Discounting	49 11
Dec. 13	To F. T. Bank –	
	Commission	20 0 0
	Discounting	49 0 11

(c) Short Bills

This is a term applied to bills which have been paid into the bank for collection to await maturity. They must not be confused with discounted bills, and no entry whatever need be made in the books, except by way of memorandum. Sometimes, however, for the sake of convenience, separate bills accounts are kept for the various collecting banks, which accounts are debited with all bills paid in to them for collection, and credited when the bills are met or dishonoured. It should be remembered, however, that the banks are not debtors for these bills, but only hold them as agents for collection.

In no circumstances should a short bill paid into the bank for collection be entered in the cash book until it is met.

(d) Documentary Bills

When the seller of goods which are to be exported wishes to obtain payment therefor, or acceptance of a bill, before the goods are actually delivered, he may, by arrangement with the consignee, draw a bill upon him for the value of the goods, and attach to

the draft a copy of the invoice and the bill of lading. Such a draft is termed a *documentary bill*. The *bill of lading* is the receipt of the master of the ship for the goods, and the document of title thereto. It also provides evidence of the contract of affreightment. These documents are handed by the consignor to his banker, who in turn forwards them to his own correspondent in the place where the consignee carries on business. To obtain the goods, the consignee must obtain the bill of lading, and he cannot get this unless he either meets or accepts the bill, according to the instructions given to the bankers.

As a general rule the consignee is notified of the fact that a bill has been drawn upon him and if he accepts the bill before the arrival of the goods he does so conditionally 'against documents'.

The English banker, upon receiving notification from his correspondent that the bill has been accepted or met, as the case may be, credits the seller of the goods with an equivalent amount, subject to his collecting charges.

Alternatively the bill may be discounted in the first instance, the same procedure being followed.

Where goods are imported, payment is usually effected in a similar manner.

(e) Rebated Bills

In some cases bills are met before their due date, *i.e.*, retired under rebate, usually for the purpose of obtaining possession of goods or documents against which the bill was drawn and which cannot be released until the bill is discharged. Where this is done a rebate is allowed, representing interest on the amount of the bill for the period unexpired, based upon the current market rate of interest.

On retiring a bill under rebate the cash book is credited and Bills Payable Account debited with the net amount paid in discharge of the bill, while the amount of the rebate is credited to Interest Account (or to Discounting Charges Account), and debited to Bills Payable Account.

PARTNERSHIP ACCOUNTS

§ 1. The Nature of Partnership

The law of partnership is contained in the Partnership Act, 1890, and in the Limited Partnerships Act, 1907, the former consolidating the law then existing into the form of a code, and the latter amending it to permit of limited liability under certain conditions.

Partnership is defined by the Partnership Act, 1890, as 'the relation which subsists between persons carrying on a business in common with a view of profit'. The participation in profits is not, however, in itself conclusive evidence of the existence of a partnership, the relationship resting upon mutual intention. Section 2 of the Partnership Act, 1890, sets forth circumstances where a person so participating would not necessarily be deemed to be a partner; *e.g.*, the receipt of remuneration by a servant on the basis of a share of profits, or the payment to the widow of a deceased partner of an annuity consisting of a portion of the profits. It is a matter of considerable importance to the persons interested, since where a partnership exists, each partner incurs unlimited liability for all the debts and obligations of the firm.

In the event of any person advancing money to the firm on loan, and receiving a rate of interest varying with the profits, or an actual share of profits, it is essential for him to see that the agreement is in writing and signed by, or on behalf of, all the parties, in order that he may not be held liable as a partner, with consequent risk of being called upon to meet the liabilities of the firm (Partnership Act, 1890, Section 2). The lender in the circumstances mentioned would be subject to a further disability, inasmuch as in the event of the bankruptcy of the firm, his claim would rank after those of the other unsecured creditors (Partnership Act, 1890, Section 3).

Persons may be co-owners of property, and may derive a profit from the use of such property, but co-ownership does not of itself constitute a partnership. The true test in such cases is whether a business is being carried on and whether every co-owner is empowered to act as agent for the other or others. Partnership entails the mutual agency of the partners. Each partner, while himself a principal, is an agent for the other partners within the scope of the business carried on, and the other partners are bound by his acts so performed. The mere co-ownership of property does not imply such a condition.

Not more than 20 persons (or 10 in the case of a banking business) can constitute a partnership for carrying on a business. If associations with more than this number carry on business they are illegal bodies and are unable to enforce any rights under contracts into which they may have entered, unless they are registered under the Companies Act or under some other Act of Parliament, or are formed under a Royal Charter.

Partners are entitled to rely upon the utmost good faith of their co-partners, both in the inception of the partnership agreement and in the carrying out of its terms. The partnership agreement is therefore of the class *uberrimæ fidei*, as between the partners.

Partnerships may be formed for a specified term or for an indefinite period. When no period is fixed, they are termed 'partnerships at will', and any partner is entitled to retire upon giving reasonable notice to his co-partners. Where the partnership has been formed for a fixed term it may be dissolved when that term has expired, but if the partnership is allowed to continue it becomes a partnership at will, unless an agreement is entered into for a new term.

Persons in partnership may, in the same way as persons carrying on business as sole traders, select whatever name they choose as the firm name. If, however, a name is selected, similar to that under which another business is carried on, so that people are induced to deal with the firm in the belief that they are dealing with the other business of that name, the Court will afford protection to the proprietors of the other firm by granting an injunction restraining the new firm from using the name.

Where the name selected does not consist of the true surnames of *all* the partners with no addition thereto other than christian names or initials, registration is necessary under the Registration of Business Names Act, 1916. The information which must be supplied to the registrar consists of:

(1) the business name;

(2) the general nature of the business;

(3) the principal place of business;

(4) the present christian name and surname, any former christian name or surname, the nationality, the usual residence, and the other occupations (if any) of each of the partners and the corporate name and registered or principal office of every corporation which is a partner;

(5) the date of commencement of the business.

Any changes in these particulars must be notified. The register is open to inspection, so that anyone may discover who the partners are. Firms which come within the operation of the Act must disclose, in legible characters, the full names and any former names of the partners on all trade catalogues, trade circulars, showcards and business letters (initials may be used instead of the full christian names).

§ 2. The Partnership Agreement

Since the essence of partnership is mutual agreement, it is most desirable for the partners to come to some understanding at the commencement as to the conditions upon which the business is to be carried on, and their relations *inter se*.

The Act lays down certain rules to be observed in the absence of agreement. The circumstances must determine whether these rules are applicable in the particular case, and since many matters should be decided which are not included in these rules, it is desirable that a formal agreement be entered into with a view to preventing disputes

in the future. The advantages of a written agreement need no emphasis, and it is preferable that it should be under seal, since the character of a deed precludes contradiction by any party of the terms which have been agreed.

Even though a formal agreement is entered into, this does not preclude subsequent variation where changing circumstances demand it; such variation can always be effected with the consent of all the partners which may be evidenced by an amending agreement, or be inferred from a course of dealing (Section 19).

(a) Clauses relating to Accounts in Partnership Agreements

The general provisions affecting questions of accounts that should be contained in all partnership agreements, apart from any special circumstances, are as follows:

(1) As to capital; whether each partner should contribute a fixed amount or otherwise.

(2) As to the division of profits and losses between the partners, including capital profits and losses.

(3) Whether the capitals are to be fixed, drawings and profits being adjusted on current accounts, or whether they are to be adjusted on the capital accounts.

(4) Whether interest on capital or on drawings, or both, is to be allowed or charged before arriving at the profits divisible in the agreed proportions, and if so, at what rate.

(5) Whether current accounts (if any) are to bear interest, and, if so, at what rate.

(6) Whether partners' drawings in advance of profits are to be limited in amount.

(7) Whether partners are to be allowed remuneration for their services before arriving at profits and if so, the amounts thereof.

(8) That proper accounts shall be prepared at least once a year and that these shall be audited by a professional accountant, and signed by all the partners.

(9) That such accounts when duly signed shall be binding on the partners, but shall be capable of being reopened within a specified period on an error being discovered.

(10) The method by which the value of goodwill shall be determined in the event of the retirement or death of any of the partners.

(11) The method of determining the amount due to a deceased partner and the manner in which the liability to his personal representatives is to be settled, *e.g.*, by a lump sum payment within a specified period, by instalments of certain proportions, etc., and the rate of interest to be allowed on outstanding balances.

(12) In the event of there being any partnership insurance policies, the method of treating the premiums thereon and the division of the policy money.

(b) Rules as to the Rights and Duties of Partners in the absence of Agreement

Section 24 of the Partnership Act, 1890, *which applies to all partnerships in the absence of any agreement to the contrary*, provides as follows:

The interests of partners in the partnership property, and their rights and duties in relation to the partnership shall be determined, subject to any agreement, express or implied, between the partners, by the following rules:

(1) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm.

(2) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him—

(*a*) in the ordinary and proper conduct of the business of the firm; or

(*b*) in or about anything necessarily done for the preservation of the business or property of the firm.

(3) A partner making, for the purpose of the partnership, any payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of 5 per cent. per annum from the date of the payment or advance.

(4) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him.

(5) Every partner may take part in the management of the partnership business.

(6) No partner shall be entitled to remuneration for acting in the partnership business.

(7) No person may be introduced as a partner without the consent of all existing partners.

(8) Any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without the consent of all existing partners. (In the absence of any agreement to the contrary no majority of partners may expel a partner (Section 25).)

(9) The partnership books are to be kept at the place of business of the partnership (or the principal place, if there is more than one), and every partner may, when he thinks fit, have access to and inspect and copy any of them.

The *duties* of partners are as under:

(*a*) To act with the utmost good faith in his relations with his co-partners.

(*b*) To render true accounts and full information of all things affecting the partnership to any partner or his legal representatives (Section 28).

(*c*) To account to the firm for any benefit derived by him without the consent of the other partners from any transaction concerning the partnership, or from any use by him of the partnership property, name or business connection (Section 29).

(*d*) To refrain from competing with the firm. Where a partner, without the consent of his co-partners, carries on a competing business, he must account for and pay over to the firm all profits made by him in that business (Section 30).

§ 3. The usual Adjustments necessary in Partnership Accounts

Before ascertaining the profits which are divisible in the agreed proportions, adjustments are frequently necessary in respect of all or any of the following matters:

(a) Interest on Capital

By charging against profits interest at a fair rate on the capital employed in a business, it can be seen whether the balance of profit remaining is sufficient to justify its continuance with unlimited liability, since the interest charged may be regarded as approximately the income the partners would have derived from the investment of their capital in securities. Apart from this, however, where there are two or more partners with unequal capitals, the effect of charging interest on capital is to adjust the rights of the partners *inter se* as regards capital, giving each of them a reasonable return on his capital before dividing the balance of profit. In those cases where the capital is fixed, and the profits are shared in the same proportions as the capital is held, the charging of interest makes no difference to the ultimate amount credited to each partner. Even in such cases, however, it is advisable to charge interest for the first reason mentioned above.

Interest on capital should be calculated for the period during which the business has had the use of the capital, allowance being made for any additions to, or withdrawals from, capital during the period. The partners' Capital or Current Accounts will be credited with the amount of interest, and Interest on Capital Account debited. At the close of the accounting period the Interest on Capital Account will be closed by transfer to the Profit and Loss Appropriation Account.

It may happen that the profits of the business in a year are insufficient to cover the interest on capital credited to the partners. In such circumstances, unless the partnership agreement provides an alternative method, the interest should be charged in full, the resulting 'loss' being divided between the partners in the proportions in which they share profits and losses. In this manner the *real* result of the trading for the period is disclosed. The partnership agreement might provide, however, that such profit as is available may be credited to the partners as interest as some compensation for the inequality of capital. The matter must be determined by the exact terms of the partnership agreement.

As already shown, partners are not entitled to interest on capital unless the payment thereof is expressly authorised by the partnership agreement.

Illustration

A, B and C, sharing profits and losses equally, have capitals of £10,000, £5,000 and £2,000 respectively, on which they are entitled to interest at 5%. The profits for the year, before charging interest on capital, amounted to £550. Show how the profits will be divided between the partners. Calculate to the nearest £.

APPROPRIATION ACCOUNT

	£	£		£	£
To Interest on Capitals –			By Profit for the year		550
A	500		„ Balance transferred to Current Accounts –		
B	250		A	100	
C	100		B	100	
		850		100	
					300
		£850			£850

PARTNERS' CURRENT ACCOUNTS

	A	B	C		A	B	C
	£	£	£				
To Appropriation Account: Loss ..	100	100	100	By Interest on Capital	500	250	100
„ Balance c/d.	400	150	—				
	£500	250	100		£500	250	100
				By Balance b/d.	400	150	

If the agreement provided that such profit as was available should be taken as interest on capital the following would be the position:

APPROPRIATION ACCOUNT

	£	£		£
To Interest on Capitals –			By Profit for the year	550
A 10/17ths .. .	323			
B 5/17ths	162			
C 2/17ths	65			
		550		
		£550		£550

(b) Interest on Drawings

Frequently partners make drawings in varying amounts and at irregular intervals, and in such cases if interest is charged the rights of the partners are adjusted. In many cases, however, drawings are made by mutual agreement and no interest is charged at all.

Where interest is charged, it is usually calculated at a fixed rate per cent. per annum from the date of each drawing to the date the accounts are closed, the amount being credited to Interest on Drawings Account, and debited to the partners' Drawings Accounts. At the close of the accounting period the Interest on Drawings Account is closed by transfer to the Profit and Loss Appropriation Account.

(c) Partners' Salaries

As already stated, in the absence of agreement no partner is entitled, before arriving at the amount of divisible profits, to remuneration for his services to the firm. In the following cases, however, it may be desirable for the partnership agreement to provide for the payment of salaries to the partners:

(1) Where some of the partners take a greater or more effective part in the conduct and management of the business than others.

(2) Where there are junior partners, whom it is desired to remunerate by way of a fixed salary plus, perhaps, a small percentage of the profits.

(3) Where the partnership business is wholly managed by the partners, and it is desired to ascertain the true profit, after such a charge for managerial services has been made as would have been incurred had the business not been managed by the proprietors.

Where the agreement provides for the payment of salaries to partners, it must be realised that such payments, although designated salaries are, like interest on capital,

merely in the nature of preferential shares of the divisible profit. The amounts of such salaries should, therefore, be debited to Profit and Loss Appropriation Account, and credited to the partners' Current or Capital Accounts, the actual payments, when made, being treated as drawings and debited to the partners' Capital or Current Accounts. Alternatively, if the partners' salaries are drawn at regular intervals, they may be debited direct from the Cash Book to the partners' Salaries Accounts, which accounts should ultimately be closed by transfer to the Profit and Loss Appropriation Account.

Illustration

Duck, Drake and Cygnet carried on a retail business in partnership. The partnership agreement provides that:

(1) The partners are to be credited at the end of each year with salaries of £1,000 to Duck and £500 each to Drake and Cygnet, and with interest at the rate of 5 per cent per annum on the balances at the credit of their respective capital accounts at the commencement of the year.

(2) No interest is to be charged on drawings.

(3) After charging partnership salaries and interest on capital, profits and losses are to be divided in the proportion: Duck, 50 per cent., Drake 30 per cent. and Cygnet 20 per cent., with the proviso, however, that Cygnet's share in any year (exclusive of salary and interest) shall not be less than £1,000, any deficiency to be borne in profit sharing ratio by the other two partners.

The Trial Balance of the firm at 31st December, 19.. was as follows:

	Dr. £	Cr £
Partners' Capital Accounts		
Duck - Balance 1st January		8,000
Drake ,, ,,		5,000
Cygnet ,, ,,		3,000
Partners' Current Accounts:		
Duck Balance 1st January		1,600
Drake ,, ,,		1,200
Cygnet ,, ,,		800
Sales		46,500
Trade Creditors		3,700
Shop Fittings at cost	3,600	
,, ,, Provision for Depreciation, 1st January		1,400
Freehold Premises - cost	6,000	
Leasehold Premises purchased during year	4,500	
,, ,, - additions and alterations	2,500	
Purchases	28,000	
Stock on hand, 1st January	4,200	
Salaries and Wages	6,400	
Office and Trade Expenses	4,520	
Rent, Rates and Insurance	1,050	
Professional Charges	350	
Debtors	2,060	
Provision for Doubtful Debts, 1st January		50
Balance at bank	4,370	
Drawings, other than monthly payments:		
Duck	1,700	
Drake	1,100	
Cygnet	900	
	£71,250	£71,250

You are given the following additional information:

(1) Stock on 31st December was valued at £3,600.

(2) A debt of £60 is to be written off and the provision against the remaining debtors should be 5 per cent.

(3) Salaries and Wages include the following monthly drawings by the partners: Duck £50, Drake £30, Cygnet £25.

(4) Partners had during the year been supplied with goods from stock and it was agreed that these should be charged to them as follows: Duck £60, Drake £40.

(5) On 31st December, rates paid in advance and office and trade expenses owing were £250 and £240 respectively.

(6) Depreciation of shop fittings is to be provided at 5 per cent. per annum on cost.

(7) Professional Charges include £250 fees paid in respect of the acquisition of the leasehold premises, which fees are to be capitalised.

(8) The cost of and the additions and alterations to the leasehold premises were to be written off over twenty-five years, commencing on 1st January in the year in which the premises were acquired.

You are required to prepare:

(*a*) the Trading and Profit and Loss Account for the year ended 31st December, 19...

(*b*) the Balance Sheet as on that date; and

(*c*) Partners' Current Accounts in columnar form for the year ended 31st December, 19...

DUCK, DRAKE AND CYGNET

TRADING AND PROFIT AND LOSS ACCOUNT

(*a*) For the Year Ended 31st December, 19..

	£	£		£
To Stock, 1st January		4,200	By Sales	46,500
„ Purchases		28,000	„ Goods supplied to partners	100
		32,200		
Less Stock, 31st December		3,600		
Cost of Sales		28,600		
„ Gross Profit, carried down		18,000		
		£46,600		£46,600
To Salaries and Wages		5,140	By Gross Profit, brought down	18,000
Office and Trade Expenses		4,760		
Rent, Rates and Insurance		800		
Professional Charges		100		
Bad Debts		110		
Amortization of Leasehold Premises		290		
Depreciation of Shop Fittings		180		
Net Profit, carried down		6,620		
		£18,000		£18,000
To Partners' Salaries:			By Net Profit, brought down	6,620
Duck	1,000			
Drake	500			
Cygnet	500			
		2,000		
„ Interest on Capital:				
Duck	400			
Drake	250			
Cygnet	150			
		800		
„ Shares of Net Profit:				
Duck, 50 per cent.	1,910			
Less Transfer to Cygnet	147			
		1,763		
Drake, 30 per cent.	1,146			
Less Transfer to Cygnet	89			
		1,057		
Cygnet, 20 per cent.	764			
Add Transfer from Duck and Cygnet	236			
		1,000		
		£6,620		£6,620

(b) BALANCE SHEET as on 31st December, 19..

		£					£
CAPITAL ACCOUNTS:			FIXED ASSETS:				
Duck	8,000		Freehold Premises – cost				6,000
Drake	5,000		Leasehold Premises – cost			7,250	
Cygnet	3,000		*Less* Provision for amortization			290	
		16,000					6,960
CURRENT ACCOUNTS:			Shop Fittings – cost			3,600	
Duck	2,403		*Less* Provision for depreciation			1,580	
Drake	1,507						2,020
Cygnet	1,250						
		5,160					14,980
		21,160	CURRENT ASSETS:				
			Stock			3,600	
CURRENT LIABILITIES			Debtors		£2,000		
Trade Creditors	3,700		*Less* Provision for Doubtful Debts		100		
Expense Creditors	240					1,900	
		3,940	Payments in Advance			250	
			Balance at Bank			4,370	
							10,120
		£25,100					£25,100

(c) PARTNERS' CURRENT ACCOUNTS

	Duck £	Drake £	Cygnet £		Duck £	Drake £	Cygnet £
To Goods	60	40	—	By Balances, brought forward	1,600	1,200	800
„ Cash	2,300	1,460	1,200	„ Salaries	1,000	500	500
„ Balance, carried forward	2,403	1,507	1,250	„ Interest on Capital	400	250	150
				„ Share of Profit	1,763	1,057	1,000
	£4,763	£3,007	£2,450		£4,763	£3,007	£2,450
				By Balances, brought forward	2,403	1,507	1,250

§ 4. Partners' Fixed Capital Accounts; Current Accounts; Loan Accounts

(a) Fixed Capital and Current Accounts

Where, as is usual, the partnership agreement provides for a fixed amount of capital to be contributed by each partner, it is preferable for the amounts thereof to be credited to the respective partners' Capital Accounts, and for partners' drawings, salaries, interest on capital and shares of profit to be dealt with in Current Accounts, as in the last preceding illustration. This enables a clear distinction to be made in the accounts between fixed capital (no part of which should be withdrawn, except by agreement) and undrawn profits. If partners' drawings, salaries, interest and shares of profit are passed through the Capital Accounts, the balances on these accounts will be constantly fluctuating, and there may be a danger of a partner's capital being depleted by drawings in excess of his share of profits, etc., without particular attention being drawn to the fact.

(b) Partners' Loan Accounts

Where a partner makes an advance to the firm as distinct from capital, the amount thereof should be credited to a separate Loan Account, and not to the partner's Capital Account. This is important, since under the Partnership Act, 1890, advances by partners are repayable on dissolution in priority to capital. Moreover, even in the absence of agreement on the point, a partner is entitled, under the Partnership Act, 1890, to interest at 5 per cent per annum on advances made to the firm, whereas he is not entitled to interest on capital. Interest on a partner's advance at the agreed rate (or, in the absence of agreement, at 5 per cent per annum) should be credited to his

Current Account, and debited to Profit and Loss Account. In this respect also, an advance by a partner differs from capital contributed by him, since interest on the advance is as much a charge against profit as interest paid on a loan from a person who is not a partner. Interest on capital, on the other hand, is an appropriation of profit, being in the nature of a preferential allocation of divisible profits.

§ 5. Goodwill in Partnership Accounts

(a) Definition and Valuation of Goodwill

The following are some judicial definitions of goodwill:

'The goodwill of a business is the advantage, whatever it may be, which a person gets by continuing to carry on, and being entitled to represent to the outside world that he is carrying on a business, which has been carried on for some time previously' (Warrington, J., in *Hill* v. *Fearis* (1905), 1 Ch. 466).

'[Goodwill] is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start . . . Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here, and another there' (Lord Macnaughten in *Commissioners of Inland Revenue* v. *Muller* (1901), A.C. 217).

From the accountant's viewpoint, goodwill, in the sense of attracting custom, has little significance unless it is valuable in the sense of having a saleable value. To the accountant, therefore, goodwill may be said to be that element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn profits greater than the return normally to be expected on the capital invested in the assets employed in the business. In considering the return normally to be expected, regard must be had to the nature of the business, the risks involved, fair management remuneration and any other relevant circumstances.

The goodwill possessed by a firm may be due, *inter alia*, to the following:

(*a*) The location of the business premises.

(*b*) The nature of the firm's products or the reputation of its service.

(*c*) The possession of favourable contracts, complete or partial monopoly, etc.

(*d*) The personal reputation of the partners.

(*e*) The possession of efficient and contented employees.

(*f*) The possession of trade marks, patents or a well-known business name.

(*g*) The continuance of advertising campaigns.

(*h*) The maintenance of the quality of the firm's product, and development of the business with changing conditions.

(*i*) Freedom from legislative restrictions.

Although a firm may possess goodwill, it is not customary to raise an account

therefor in the books except to the extent that cash or other assets of the firm have been used to pay for it. It follows, therefore, that when goodwill exists and is unrecorded in the books, the capitals of the partners of the firm are understated to the extent of the value of the goodwill. Even though a Goodwill Account may at some time have been raised in the books, the account therefor would not be adjusted to give effect to every variation in its value, and in most cases, therefore, the partners' capitals are to some extent under-stated or over-stated in the books by their shares of the unrecorded appreciation or depreciation in the value of goodwill.

As the amount by which goodwill is undervalued (or overvalued) in the books is a profit (or a loss) to be shared by the partners in their profit-sharing ratio, any alteration in the proportions in which profits and losses are shared, without first making an adjustment in the book value of goodwill, will result in an advantage to one or more partners and a disadvantage to others.

In each of the following cases a change in the profit-sharing ratio takes place and therefore, unless a Goodwill Account already stands in the books *at its correct value*, some adjustment must be made:

(1) upon the introduction of a new partner;

(2) upon the retirement or death of a partner;

(3) upon an agreed change in profit-sharing ratio between the partners.

Various methods are advocated for the valuation of goodwill. In many cases the method adopted is a purely arbitrary one and is often governed by the custom of the particular trade in which the business is engaged. The more usual bases of valuation are as follows:

(*a*) The average profits of a given number of past years multiplied by an agreed number. Thus, 'three years' purchase of the net profits' is commonly spoken of as the basis upon which goodwill is to be valued.

This method is purely arbitrary and will frequently produce a figure for goodwill out of all proportion to its true value.

Illustration (1)

The average net profit made by A, B & Co. for the past five years has been £1,000 per annum before charging interest on capital and partners' salaries.

The average capital employed in the business has been £10,000.

On the basis of three years' purchase of the net profits £3,000 would be payable for the goodwill of the firm, but it is apparent that no goodwill exists and, in fact, there is *badwill*, since no one would be prepared to pay £13,000 for a business which produces only £1,000 per annum before making any provision for fair remuneration to the proprietors in respect of their services to the business. Allowing say £500 per annum for the services of the proprietors, only £500 per annum remains for interest on capital invested and, therefore, at 10% per annum such a business would be worth only £5,000, irrespective of the fact that there is £10,000 invested therein.

(*b*) The average *gross* income of the business for a number of past years multiplied by an agreed number.

This method is frequently adopted by professional firms, but is subject to the disadvantages described above. In many cases the gross income of certain years will have been inflated by business of a non-recurring nature, and therefore the purchaser will be paying for goodwill calculated on income which he himself will not enjoy. Further, it is quite conceivable that the expenses incurred in earning the gross income may be so great that there is actually a loss, in which case a sum will be payable for the 'goodwill' of a business from which a loss is to be expected.

(*c*) The capital value of an annuity for an agreed number of years of an amount equal to the average *super profits* of the business.

The *super profits* of a business are the profits which can be expected in the future over and above those necessary to pay a fair return upon the capital invested in the business, having regard to the risk involved in that particular business, and a fair remuneration for the services of the partners who work therein.

Illustration (2)

The average net profits expected in the future by A, B & Co. are £10,000 per annum.

The average capital employed in the business is £50,000.

The rate of interest expected from capital invested in this class of business, having regard to the risk involved, is 10%.

Fair remuneration to the partners of the firm in respect of their services to the business is £2,500 per annum.

Valuation of Goodwill

	£	£
Average annual profits ..		10,000
Less Interest on capital employed at 10% ..	5,000	
Partners' remuneration	2,500	
		7,500
Annual super-profit		£2,500

It is now necessary to ascertain the present value of an annuity of £2,500 per annum for a suitable number of years. Alternatively, '*x* years' purchase' of £2,500 may be taken as the value of goodwill, according to the number of years that could be regarded as necessary to build up such a goodwill, discounted by reference to the fact that any goodwill purchased is a wasting asset, since the influence of the vendor diminishes as that of the purchaser increases.

(*d*) The value of the business as a going concern is estimated by reference to the expected earnings and the yield required, and from the figure arrived at the value of the net *tangible* assets is deducted, the difference being taken to represent the value of goodwill.

Illustration (3)

	£
Estimated future annual profit ..	10,000
Less Partners' remuneration ..	2,500
Available for interest on capital employed	£7,500

Assuming a yield of 10% per annum is expected the capital value of the business is £75,000. If the value of the net tangible assets of the business is £50,000 the goodwill is worth a maximum of £25,000. This figure would have to be discounted in many cases, as there is a bigger risk in the earning of super-profits than in the earning of a fair return on money invested in more tangible assets.

(b) Methods of treating Goodwill in the case of an Incoming Partner

It has already been stated that if the value of goodwill is unrecorded in the books the Capital Accounts of the partners are understated.

Assume that the following is the Balance Sheet of the firm of A and B, who share profits, two-thirds and one-third respectively:

A AND B

BALANCE SHEET

					£
Capital Accounts:			Land and Buildings ..		5,250
A ..	£8,500		Plant and Machinery ..		3,075
B ..	3,500		Stock-in-Trade ..		4,500
		12,000	Book Debts .	£3,000	
			Less Provision ..	150	
Sundry Creditors		3,975			2,850
			Cash at Bank		300
		£15,975			

The goodwill of the firm is valued at £6,000 and, therefore, the true capitals of A and B are £4,000 and £2,000 respectively more than the amounts standing to the credit of their Capital Accounts. As these increments arise from the fact that goodwill is not recorded in the books, it is apparent that some adjustment must be made in the event of the introduction of a new partner, in order that he shall not take a share of goodwill without payment.

There are, for all practical purposes, three methods of dealing with the question of goodwill upon the introduction of a new partner.

(1) An account is raised in the old firm's books for the full value of goodwill, the old partners' Capital Accounts being credited therewith in the proportions in which they share profits or losses. The new partner may or may not bring in capital according to the agreement. In any event, whatever he brings in will be credited to his Capital Account. The effect of this method is to increase the old partners' Capital Accounts to the extent of the value of goodwill previously unrecorded.

Illustration (1)

Assuming the facts given above, A and B agree to admit C into partnership, giving him a one-fifth share of profits; C to bring in capital to the extent of one-quarter of the combined capitals of A and B after adjustment for goodwill. A's and B's proportions of profit in the new firm are to be in the same ratio between themselves as before.

Give journal entries recording these transactions, and prepare the Balance Sheet of the new firm, assuming C to have brought in the requisite cash, stating the proportion in which profits will in future be shared.

JOURNAL

Goodwill	Dr.	6,000	
To A Capital Account			4,000
B " "			2,000
Being creation of Goodwill as agreed on admittance of C into partnership.			
Cash	Dr.	4,500	
To C Capital Account			4 500
Being Capital brought in, one-fourth of £12,000 + £6,000.			

A, B and C
BALANCE SHEET

					£
Capital Accounts:			Goodwill		6,000
A	£8,500		Land and Buildings		5,250
Add Goodwill	4,000		Plant and Machinery		3,075
		12,500	Stock-in-Trade		4,500
B	3,500		Book Debts	£3,000	
Add Goodwill	2,000		*Less* Provision	150	
		5,500			2,850
		4,500	Cash at Bank		4,800
Sundry Creditors		3,975			
		£26,475			£26,475

As C is to receive one-fifth of the profits, the remaining four-fifths must be divided—$\frac{2}{3} \times \frac{4}{5}$ to A $= \frac{8}{15}$
$\frac{1}{3} \times \frac{4}{5}$ to B $= \frac{4}{15}$ $\Big\} = \frac{12}{15}$
leaving $\frac{1}{5}$ C $= \frac{3}{15}$

Note to Illustration.

Since the goodwill now stands in the books at its full value, and the amounts thereof attributable to A and B are included in the amounts standing to the credit of their Capital Accounts, if the business were sold and the goodwill realised its book value, A and B would automatically receive cash for their shares of the goodwill. If, on the sale of the business, the goodwill realised more or less than its book value, the difference would represent a profit or loss arising *after* the admission of C as a partner, and would be divided between A, B *and* C in their new profit-sharing ratio, *viz.* 8 : 4 : 3.

It is sometimes agreed, on the admission of a new partner, that he shall acquire a share of goodwill, without payment, over a period of years. This recognises the fact that the goodwill existing at the date of the new partner's admission is constantly in the process of attenuation and of being replaced by a new goodwill, to the building up of which the new partner has contributed. Effect may be given to such an agreement by writing off the book value of the goodwill over an agreed period of years against the Capital Accounts of the old partners in the proportions in which the goodwill was originally credited to them. For example, if, in the above illustration, it were agreed that C should acquire his share of the firm's goodwill, without payment, over ten years, in each year £600 should be written off the goodwill account, A's capital account being debited with £400 and B's with £200. By this means goodwill would disappear from the books by the end of the ten years, and would become an undisclosed asset, the proceeds of which, if sold, would be divisible between A, B and C in profit-sharing ratio. C would thus have acquired his share of the goodwill without making any payment to A and B. Alternatively, if it is desired to retain goodwill in the books at £6,000 instead of writing down the goodwill by £600 a year C's Capital Account would be credited with one-fifth of that amount, viz., £120, A's Capital Account

being debited with £80 and B's with £40. In this way C's Capital Account would be credited over the period of ten years with £1,200, being the value of his one-fifth share of the book value of the goodwill. A's and B's accounts being debited with £800 and £400 respectively.

(2) No Goodwill Account is raised in the books, but the proportion of the agreed value of goodwill attributable to the incoming partner's share of profit is paid for by him in cash. The additional cash brought in by the new partner for the acquisition of a share of goodwill is credited to the Capital Accounts of the old partners in the proportions in which they shared profits before the introduction of the new partner. The cash brought in by the new partner as his capital will be credited to his Capital Account in the normal manner.

Illustration (2)

Assuming the same facts as for the previous example, but that no goodwill account is to be opened in the books on C's admission, the latter introducing £3,300 as his capital and £1,200 for his share of goodwill.

Show by journal entries the adjustments to be made on C's introduction, and the Balance Sheet of the new firm.

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		£	
Cash	*Dr.*	1,200	
To Capital Accounts:			
A two-thirds			800
B one-third ..			400
Being payment by C for a one fifth share in the Goodwill.			
		£	£
Cash . .		3,300	
To C Capital Account			3,300
Being Capital introduced by C			

A, B AND C
BALANCE SHEET

		£			£
Capital Accounts:			Land and Buildings		5,250
A ..	£9,300		Plant and Machinery		3,075
B ..	3,900		Stock-in-Trade		4,500
C .	3,300		Book Debts	£3,000	
		16,500	*Less* Provision	150	
Sundry Creditors		3,975			2,850
			Cash at Bank		4,800
		£20,475			£20,475

(3) The third method is similar to the second, with the exception that the money paid by the incoming partner for goodwill is not left in the business as working capital, but is paid to the old partners personally in proportion as they share profits and losses. In this case there will be no entries in the books, unless the amount is first paid into the firm's account and then withdrawn, in order to keep some record of the transaction. Naturally this method is the least advantageous of all to the incoming partner, as the money which he pays for goodwill is not utilised for the general benefit of the business. It must be appreciated that it is only in the ultimate disposition of the cash that this method differs from the second.

By methods (2) and (3) the old partners, A and B, are compensated in cash for the shares of their existing goodwill which they surrender to C, and the goodwill remains an undisclosed asset, the proceeds of which, if sold, would now be divided between A, B and C in their agreed profit-sharing ratio. C would thus recover the sum paid by him for a share of goodwill, plus or minus his share of any increase or reduction in its value since he became a partner.

(4) Where the goodwill stands in the books at less than its true value, on the admission of a new partner either of the following courses may be followed:

(*a*) The book value of the goodwill may be entirely written off against the old partners' capital accounts in their original profit-sharing ratio. Any cash paid by the new partner for a share of goodwill would then be credited to the old partners, as in method (2) or (3) above.

(*b*) The book value of the goodwill may be written up to its full value by crediting the old partners in profit-sharing ratio, with their shares of the amount by which the goodwill is written up. The position would then be as in method (1) and any sum paid in by the new partner would be credited to his Capital Account.

(*c*) If it is desired to retain the goodwill in the books at its existing book value, the incoming partner should only be required to pay for a share of the *undisclosed* goodwill. For example, if in the above illustration the goodwill stood in the books at £1,000, its true value being £6,000, and it was desired to retain the asset in the books at £1,000, C should only pay to A and B in respect of his share of goodwill one-fifth of £5,000 = £1,000, which sum should be credited to A and B in profit-sharing ratio. The capital accounts of A and B are already credited with their respective shares of the £1,000 goodwill appearing in the books and they are, therefore, entitled to no payment from C in respect thereof.

(c) Goodwill affecting Outgoing Partners

When a partner retires or dies, it is usual for his share of the goodwill to be determined, either according to the terms of the original agreement or by valuation, and for such an amount to be credited to his Capital Account as represents his proportion of the value of the goodwill according to his share of the profits.

It will be appreciated, however, that such an adjustment would not be necessary if an account for goodwill, at its correct value, already stood in the books of the firm.

The amount to be credited to the retiring or deceased partner's account in respect of goodwill may be debited to Goodwill Account, or, if it is preferred that no Goodwill Account shall be raised, or that the balance appearing on an existing Goodwill Account shall not be altered, to the Capital Accounts of the remaining partners in their profit-sharing proportions.

Illustration

The following is the Balance Sheet of A, B & Co. on 31st December 19.. on which date A retires. Profits and losses have been shared in the ratio of 3 : 2 : 1, and B and C continue the business sharing profits as 2 : 1. For the purposes of A's retirement goodwill is valued at £5,000.

BALANCE SHEET, as at 31st December 19.

Capital Accounts:				£
A	£16,000		Goodwill .. .	1,000
B	5,000		Freehold Property .	13,500
C	4,000		Plant and Machinery	2,493
		25,000	Stock-in-Trade .	6,159
Current Acc:			Sundry Debtors .	4,832
A	£400		Cash at Bank .	1,108
C	100			
		500		
Sundry Creditors		3,592		
		£29,092		£29,092

Show by journal entries the adjustments necessary on A's retirement, having regard to the fact that the partners do not wish to increase the present book value of goodwill.

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		£	
Capital Accounts:	Dr.		
B two-thirds	..	1,333	
C one-third	..	667	
To Capital Account A			2,000
Purchase from A of one-half of the unrecorded value of Goodwill.			
Current Account A	Dr.	400	
To Capital Account A ..			400
Transfer of balance on retirement.			
Capital Account A	Dr.	18,400	
To Loan Account A			18,400
Transfer of balance due to A on his retirement pending settlement.			

Note to Illustration.

As the value of goodwill has been agreed at £5,000, an increase over its book value is disclosed of £4,000. Of this sum A is entitled to one-half, and as the book value of the goodwill is not to be increased, B and C must be debited therewith in their profit-sharing proportions as they have, in effect, purchased this share of goodwill from A.

It will be appreciated that the same amount would have been credited to A had the Goodwill Account been raised to its real value, thus:

		£	£
Goodwill Account . .	Dr.	4,000	
To Capital Accounts			
A one-half			2,000
B one-third			1,333
C one-sixth			667
Adjustment necessary to increase Goodwill Account to its correct value.			

An alternative arrangement is sometimes made whereby the retiring partner or the representatives of the deceased partner receive, in lieu of an amount representing his share of the goodwill, an annuity, or a proportion of the profits, for an agreed number of years. This method is not to be recommended, however, as the ultimate amount which will be paid by the continuing partners for the old partner's share of goodwill will be uncertain and may have little bearing upon the real value of this asset.

(d) Treatment of Goodwill on a change in the ratios in which profits are shared by partners

When partners agree that the proportion in which they share profits and losses shall be changed, it is necessary for all the assets of the firm, including goodwill, to be revalued, in order that each partner may be credited or charged, before the change in the division of profits take effect, with his proper share of any unrecorded profit or loss in respect of these assets.

Illustration (1)

The following is the Balance Sheet of X, Y & Z, at 31st December 19... The partners agree that from 1st January 19.. they will share profits in the ratio of 3 2 : 1, instead of in their former ratio of 2 : 2 : 1.

X, Y AND Z

BALANCE SHEET, AS AT 31ST DECEMBER 19..

				£
Capital Accounts:			Goodwill ..	4,000
X ..	£10,000		Land and Buildings	6,000
Y ..	5,000		Plant and Machinery	4,000
Z ..	3,000		Stock ..	5,500
		18,000	Sundry Debtors	3,100
Sundry Creditors		7,500	Bills Receivable	2,000
			Cash at Bank	900
		£25,500		£25,500

The assets of the firm are revalued as under:	£
Goodwill .. .	6,000
Land and Buildings .	8,500
Plant and Machinery .	3,500
Stock .. .	5,000
Sundry Debtors .	2,600
Bills Receivable .	2,000

Show by journal entries the adjustments which must be made on the occasion of the change in the profit-sharing ratios between the partners.

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Sundries	Dr.		
To Revaluation Account			4,500
Goodwill		2,000	
Land and Buildings		2,500	
Adjustment to record increase in value of assets as at 31st December 19.			
Revaluation Account	Dr.	1,500	
To Sundries			
Plant and Machinery			500
Stock			500
Bad Debts Provision			500
Adjustment to record decrease in value of assets at 31st December 19..			
Sundries	Dr.		
To Capital Accounts:			
X two-fifths			1,200
Y two-fifths			1,200
Z one-fifth			600
Revaluation Account		3,000	
Transfer of balance as at 31st December 19.., in old profit-sharing ratio, 2 : 2 : 1.			

If it is desired to restore the assets to their original book values the above entries may be reversed, the partners being debited with the differences disclosed in their *new* profit-sharing ratio. Alternatively, to avoid writing up the assets in the first place a *Memorandum* Revaluation Account could be prepared to disclose the net increase in the value of the assets, and the following entry made:

STATEMENT SHOWING ADJUSTMENT NECESSARY

Net increase in value of assets £3,000

		X	Y	Z
		£	£	£
Proportion thereof applicable to each partner in old ratio, 2 : 2 : 1	3,000	1,200	1,200	600
Proportion thereof applicable to each partner in new ratio, 3 : 2 : 1	3,000	1,500	1,000	500
Adjustment		+ £300	—£200	—£100

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		£	£
Capital Account X	*Dr.*	300	
To Capital Accounts:			
Y			200
Z			100
Adjustment between partners consequent upon a change in the profit-sharing ratios as shown by the statement above.			

Alternatively, the net increase in the assets may be credited to the partners' Capital Accounts in their *original* profit-sharing ratio, and then written off by being debited to the Capital Accounts in the *new* ratio.

CAPITAL ACCOUNTS

	X	Y	Z		X	Y	Z
	£	£	£		£	£	£
To Revaluation Account – Net increase in value of assets written off in new ratio 3 : 2 : 1	1,500	1,000	500	By Balance b/f .. .	10,000	5,000	3,000
Balance c/d.	9,700	5,200	3,100	„ Revaluation Account – Net increase in value of assets in old ratio 2 : 2 : 1 ..	1,200	1,200	600
	£11,200	£6,200	£3,600		£11,200	£6,200	£3,600
				By Balance b/d. . .	9,700	5,200	3,100

In effect, X has purchased $\frac{3}{6}$th — $\frac{2}{5}$th = $\frac{1}{10}$th (or £300) of the net increase and is accordingly debited with that amount, whilst Y has sold $\frac{2}{5}$th — $\frac{2}{6}$th = $\frac{1}{15}$th (or £200) and Z $\frac{1}{5}$ — $\frac{1}{6}$th = $\frac{1}{30}$th (or £100) and their accounts are credited with those amounts. If the capitals are to be restored to their original amounts X must pay in £300, Y withdrawing £200 and Z £100.

In more complicated cases it may be desirable to open a special Adjustment Account, in which to record the transactions.

Illustration (2)

A, B, C, D and E are partners in A & Co., making up accounts to 31st December each year. The capital of the firm is contributed in proportion to their shares in profits and losses. No Goodwill Account appears in the books.

As from 1st January, 19.., those shares change under the partnership deed as under:

		Previous to 1st January	As from 1st January
A	..	40 per cent.	30 per cent.
B	..	30 „ „	25 „ „
C	..	15 „ „	20 „ „
D	..	10 „ „	15 „ „
E	..	5 „ „	10 „ „

The partnership deed further provides that partners whose shares increase shall purchase goodwill from the partners whose shares diminish on the basis of 2½ years' purchase of the average profits for the preceding five years.

The profits for those years were £20,700, £16,250, £17,000, £16,950 and £16,300 respectively.

The following further arrangements are made at 31st March:

(1) The capital of the firm, which was £20,000, is to be reduced as from 1st January to £18,000.

(2) A agrees to lend E £1,250 towards the sum due by E as a result of the adjustment.

(3) B receives C's personal cheque for £2,500 and A receives D's personal cheque for £2,000.

(4) E, having regard to the state of his account with the firm obtains from his wife securities, which he sells for £1,750, handing the proceeds over to the firm. D follows his example paying in £1,000.

An additional account, called 'Adjustment Account', is opened for each partner in the firm's ledger, through which the above-mentioned transactions are to be passed.

The entries incidental to the transactions and arrangements indicated above are all made in the firm's books at 31st March, on which date the Adjustment Accounts are closed by the payment in or withdrawal of cash; no record is, however, retained in those books of E's liability to pay and A's right to receive the above-mentioned loan of £1,250.

The accounts will appear as follows:

CAPITAL ACCOUNTS

	A £	B £	C £	D £	E £		A £	B £	C £	D £	E £
To Adjustment Accounts, reduction in capital	2,600	1,500		—	-	By Balances b/f.	8,000	6,000	3,000	2,000	1,000
,, Balances c/d.	5,400	4,500	3,600	2,700	1,800	,, Adjustment Accounts, increase in capital	--		600	700	800
	8,000	6,000	3,600	2,700	1,800		8,000	6,000	3,600	2,700	1,800
						By Balance b/d	5,400	4,500	3,600	2,700	1,800

ADJUSTMENT ACCOUNTS

	A £	B £	C £	D £	E £		A £	B £	C £	D £	E £
To Purchase of goodwill	—	—	2,180	2,180	2,180	By Sale of goodwill	4,360	2,180	—	—	
,, Capital Accounts	—	—	600	700	800	,, Capital Accounts	2,600	1,500	—	-	
,, C - personal cheque	—	2,500	—	—	—	,, B - personal cheque	—	—	2,500	—	
,, D - personal cheque	2,000	—	—	—	—	,, A - personal cheque	—	—		2,000	
,, E personal loan	1,250	—	—	-	—	,, Cash	—	—	—	1,000	1,750
,, Cash - to balance	3,710	1,180	—	120	20	,, A - personal loan	—	—	—	—	1,250
						,, Cash - to balance	—	—	280	—	
£	6,960	3,680	2,780	3,000	3,000	£	6,960	3,680	2,780	3,000	3,000

Notes to Illustration.

(1) The Adjustment Accounts are personal accounts for the partners, being credited with amounts due *to* them and debited with amounts due *by* them respectively in respect of the adjustments. Payments *by* partners are then credited and payments *to* them debited to their respective Adjustment Accounts.

(2) Transfers are made from Capital Accounts to Adjustment Accounts to reduce the total capital to £18,000 and to adjust the holdings of the partners to the new proportions as at 1st January.

(3) The value of the goodwill, on the basis stated, is £43,600. Since A's share of the total profit is to be reduced by 10 per cent. and B's by 5 per cent., A and B are, in effect, selling similar shares of goodwill, and their Adjustment Accounts must therefore be credited with

£4,360 and £2,180 respectively. C, D, and B are purchasing these shares in equal proportions, since the share of profit of each is to be increased by 5 per cent. Each of their Adjustment Accounts must therefore be debited with £2,180.

(4) Since no record is to be retained in the books of E's liability to pay and A's right to receive the loan of £1,250 made by A to E, this loan, so far as the firm is concerned, is tantamount to a payment *to* the firm by E and a withdrawal *by* A of £1,250. A's Adjustment Account is therefore debited, and E's credited, with £1,250. E then owes this £1,250 to A *outside* the business.

(e) Life Assurance Policies to provide for repayment of share of a deceased partner

In some cases partners effect assurance on their lives, either jointly or severally, in order to provide the cash required to pay out the whole or part of the capital and goodwill of a partner who dies. Such an assurance is of particular advantage where the surviving partners have insufficient resources outside the business to purchase a deceased partner's interest in the partnership.

Partnership life assurance may be dealt with in the accounts by any of the following methods:

(i) The premiums paid on the policy are written off to Profit and Loss Account, thereby reducing the profits divisible between, and available to be withdrawn from, the business by the partners. This has the effect of charging the partners with the cost of the assurance in the proportions in which they share profits. No account in respect of the policy appears in the books, so that the value of the policy at any time represents a secret reserve which belongs to the partners in profit-sharing ratio. Accordingly, on the death of a partner, each partner's Capital Account must be credited with his proper share of the policy money received. The cash so made available can then be applied in or towards the sum due to the representatives of the deceased partner.

The advantage of this method is that it avoids the danger of the working capital of the firm being depleted by the withdrawal of cash to pay the premiums, the cost of the assurance being borne by the partners out of their shares of profit.

(ii) A Life Policy Account is opened in the books, to which the premiums are debited as and when they are paid. The policy will thus appear in the books as an asset at cost, and the amount receivable on the death of a partner will be credited to this account, any difference between the amount standing to the debit of the account and the sum received being divided between the partners in profit-sharing ratio, and credited to their respective Capital Accounts.

Although this method has the advantage of disclosing the existence of the asset acquired by the payment of the premiums, if (as is usually the case in the early years of the policy) its surrender value is less than the total amount of the premiums paid, the policy will appear in the books at more than its current realisable value. Furthermore, as the profits disclosed by the accounts are not reduced by the premiums, if the whole of the profits are withdrawn the premiums will, in effect, have been paid out of capital, and the liquid resources of the business may become unduly depleted.

(iii) The premiums paid are debited to a Life Policy Account, as in method (ii), but the book value of the policy is adjusted each year to its surrender value by a transfer from Profit and Loss Account. This overcomes the objection, referred to in method (ii), to the policy appearing in the books at more than its realisable value. It does not, however, conserve the working capital by reducing the profits divisible between the partners.

(iv) The premiums paid are debited to a Life Policy Account, and a sum equal to the annual premium is debited each year to Profit and Loss Account and credited to a Life Policy Fund Account. The book value of the policy is then adjusted to surrender value by a transfer from the Life Policy Fund Account instead of from Profit and Loss Account. On the death of a partner the sum received under the policy will be credited to the Life Policy Account, any profit disclosed by the account being transferred to the credit of the Life Policy Fund Account. The final balance on the latter account will now represent a reserve equal to the total sum received under the policy, and will be transferred to the credit of the partners' capital accounts in their profit-sharing proportions.

This method has the advantages of disclosing the existence of the asset at its realisable value and also of avoiding the danger of depleting the working capital of the firm.

Each of the above methods is exemplified by the following illustration:

Illustration

A, B and C are in partnership, sharing profits in the proportion of two-thirds, one-sixth, and one-sixth respectively, and in order to provide cash for the immediate payment of a portion of the amount due to any one of them in the event of death, in respect of both capital and goodwill, an assurance was effected on their lives jointly for £9,000 without profits, at an annual premium of £350.

A died on the 30th June 19. ., three months after the annual accounts had been prepared, and in accordance with the partnership agreement, his share of the profits to the date of death was estimated on the exact basis of the profits for the preceding year. In addition to this, the agreement provided for interest on capital at 5 per cent. per annum on the balance standing to the credit of the capital account at the date of the last Balance Sheet, and also for goodwill, which was to be brought into account at two years' purchase of the average profits for the last three years, prior to charging the above-mentioned insurance premiums, but after charging interest on capital.

A's capital on 31st March 19. ., stood at £12,000, and his drawings from then to the date of death amounted to £900.

The net profits of the business for the three preceding years amounted to £3,350, £4,150 and £4,050, respectively, after charging interest on capital but before charging insurance premiums, or adjustments of the Policy Account to surrender value (as the case may be).

The total premiums paid on the life policy to 31st March preceding A's death amounted to £4,500, and the surrender value at that date was £4,000. In that year it became necessary to debit Profit and Loss Account with £250 in order to adjust the Policy Account to the surrender value of the policy.

You are instructed to adjust A's capital account as at the date of death, for a settlement with his executors.

METHOD (i)

A's CAPITAL ACCOUNT

	£		£
To Drawings	900	By Balance b/d.	12,000
„ Balance c/d.	23,000	„ Interest on Capital 5% for 3 months	150
		„ Profit to date of death	617
		„ Goodwill	5,133
		„ Insurance Policy, two-thirds of £9,000	6,000
	£23,900		£23,900
		By Balance b/d.	23,000

Notes

(1) The value of goodwill is arrived at as follows:

	£
Profit 1st year	3,350
„ 2nd „	4,150
„ 3rd „	4,050
	3) 11,550
Three years' average profit	£3,850
Total amount of Goodwill	£7,700

A's Share = two-thirds of £7,700 = £5,133

(2) A's share of profit for the 3 months to the date of death, based on the profit of the previous year is $\frac{2}{3} \times \frac{1}{4} \times$ £(4,050 — 350) = £617.

METHOD (ii)

A's CAPITAL ACCOUNT

	£		£
To Drawings	900	By Balance b/d.	12,000
„ Balance c/d.	20,058	„ Interest on Capital – 3 months	150
		„ Profit to date of death	675
		„ Goodwill	5,133
		„ Life Policy Account – share of profit . ..	3,000
	£20,958		£20,958
		By Balance b/d.	20,058

Note. A's share of profit is $\frac{2}{3} \times \frac{1}{4} \times$ £4,050 = £675.

LIFE POLICY ACCOUNT

				£
To Balance (Premiums paid to date) b/d. ..		4,500	By Cash	9,000
Profit—				
A two-thirds	£3,000			
B one-sixth	750			
C one-sixth	750			
		4,500		
		£9,000		£9,000

METHOD (iii)

A's CAPITAL ACCOUNT

	£		£
To Drawings	900	By Balance b/d.	12,000
„ Balance c/d.	20,350	„ Interest on Capital .	150
		„ Profit to date of death	633
		„ Goodwill	5,133
		„ Life Policy Account – share of profit	3,334
	£21,250		£21,250
		By Balance b/d.	20,350

Note

The divisible profit for the previous year was £4,050 less £250 charged to Profit and Loss Account and credited to Policy Account to adjust it to surrender value = £3,800. A's share is $\frac{2}{3} \times \frac{1}{4} \times$ £3,800 = £633.

LIFE POLICY ACCOUNT

		£		£
To Balance (surrender value) b/d.		4,000	By Cash	9,000
Profit:				
A two-thirds . ..	£3,334			
B one-sixth	833			
C one-sixth	833			
		5,000		
		£9,000		£9,000

METHOD (iv)

A's CAPITAL ACCOUNT

	£		£
To Drawings	900	By Balance b/d. ..	12,000
„ Balance c/d	23,000	„ Interest on Capital	150
		„ Profit to date of death	617
		„ Goodwill .	5,133
		„ Life Policy Fund Account	6,000
	£23,900		£23,900
		By Balance b/d.	23,000

Note

A's share of profit is as in method (i).

LIFE POLICY ACCOUNT

	£		£
To Balance b/d. .. .	4,000	By Cash	9,000
„ Life Policy Fund – Profit transferred	5,000		
	£9,000		£9,000

LIFE POLICY FUND ACCOUNT

		£		£
To Balance transferred to partners:			By Balance b/d.	4,000
A two-thirds	£6,000		„ Life Policy Account, profit transferred	5,000
B one-sixth	1,500			
C one-sixth	1,500			
		9,000		
		£9,000		£9,000

(f) Readjustment of partners' shares of profit over a period of years

When a manager or other servant of the firm is admitted into partnership, it is sometimes agreed that retrospective effect shall be given to the new arrangement, as if, from the point of view of sharing profits, he had become a partner at an earlier date. In such a case an entry must be made at the commencement of the new partnership, debiting the original members of the firm and crediting the incoming partner with the amount (if any) found to be due to him in respect of the earlier period.

Illustration

A and B have carried on business for four years, and their books show the following results:

			£
First year	..	Loss	788
Second year	..	Profit	3,635
Third year	..	..	4,129
Fourth year	..	..	5,362

The capital (in which no change has been recorded in the books during the four years) is A £30,000, B £20,000, the profits and losses being divisible in these proportions; and in addition to the capital there is a loan from C (the manager) of £5,000 at 5 per cent. The above results are after charging 4½ per cent. interest on capital, 5 per cent. interest on the loan, and C's salary of £500 per annum.

At the end of the fourth year the partners agree to adjust the accounts by treating C as a partner from the commencement, his loan of £5,000 to be regarded as capital, entitling him to one-eleventh of the profits, and carrying 4½ per cent. interest instead of the 5 per cent. paid on the loan, but his salary is reduced to £400 per annum for the whole period of four years.

Make the necessary entries to adjust the accounts to accord with the new arrangement, and show how the loss of the first year and the profits of the second, third and fourth years are divisible between A, B and C. Calculations to be made to the nearest £.

Under the new arrangement the divisions are as follows:

			£
First Year:			
Loss £788 – Interest £25 and Salary £100 = Loss £663	A	30/55	362
	B	20/55	241
	C	5/55	60
		Loss	£663
Second Year:			
Profit £3,635 + Interest £25 and Salary £100 = Profit £3,760	A	30/55	2,051
	B	20/55	1,367
	C	5/55	342
		Profit	£3,760
Third Year:			
Profit £4,129 + Interest £25 and Salary £100 = Profit £4,254	A	30/55	2,320
	B	20/55	1,547
	C	5/55	387
		Profit	£4,254
Fourth Year:			
Profit £5,362 + Interest £25 and Salary £100 = Profit £5,487	A	30/55	2,993
	B	20/55	1,995
	C	5/55	499
		Profit	£5,487

By the above arrangement C receives the following:		
Second Year..		342
Third „ ..		387
Fourth „ ..		499
		1,228
Less First Year Loss	£60	
£125 per annum for 4 years, *viz.*, £25 interest (½ % on £5,000) and £100 salary to be taken at £400 instead of £500 per annum	500	
		560
Net Credit for C		£668
Debit to A three-fifths of £668		401
„ „ B two-fifths of £668		267
		£668

A's Current Account will therefore be debited with £401, and B's with £267, C's being credited with £668.

§ 6. Outgoing Partners

In the absence of any agreement or uniform usage to the contrary, a partner, on retirement, or the representative of a deceased partner, is entitled to have the partnership assets, including goodwill, revalued on a proper basis as at the date of the retirement or death, and any appreciation or depreciation so revealed taken into account in computing the sum due to him or them. The total amount so ascertained to be due is normally a debt due by the firm to the retired partner or the representatives of the deceased partner.

An agreement may be made, however, between the partners whereby, in the event of the death or retirement of a partner, the remaining partners shall assume, personally, the liability for the amount due. In such circumstances the debt is no longer due by the firm but by the partners individually in the ratio agreed upon (*Elliott* v. *Elliott*). Where there is no agreement as to the proportions in which such liability is to be shared, the profit-sharing ratios should be taken. If an agreement of this description is made, the amount due to the retiring or deceased partner must be transferred to the credit of the capital accounts of the remaining partners in the ratio in which they have assumed the liability.

In the case of *Elliott* v. *Elliott* (1911), 45 Acct. L.R. 47, the partnership agreement provided that at the death of a partner his share in the assets and goodwill of the business should, as from the time of his death, belong to and be purchased by the remaining partners in proportion to their shares in the business, and that they should execute a joint and several bond for securing the repayment of the amount due, payment being made in eight half-yearly instalments. On the death of one partner his capital was treated as a liability of the firm, and on the death of a second partner the latter's executors brought an action to determine *inter alia* whether the debt due to the estate of the first mentioned partner should be treated as a debt of the partnership.

It was held that the amount in question was to be apportioned between and borne by the partners in the ratio in which they shared profits and losses. In the course of his judgment, Mr Justice Warrington stated that he thought it was a debt due by each partner to the deceased partner's executors as the purchase money for a personal

benefit acquired by such partner. The balance remaining due to the deceased partner's executors must, therefore, be struck out of the balance sheet of the firm.

It must, however, be appreciated that unless an agreement of this description is entered into, the amount due to the retiring partner or to the estate of a deceased partner is, as stated above, a debt due by the firm, and must be shown as such on its balance sheet.

The retiring partner, or the estate of the deceased partner, remains liable for the firm's debts at the date of retirement or death, although, as between the partners themselves, he is only responsible for his share of the liabilities. When the amount due to him has been ascertained and either repaid or taken over by the remaining partners, he should in equity be discharged from further liability, and for this reason care should be taken to obtain an undertaking from the remaining partners to indemnify him, or his estate, against any action which may be brought against him by any creditor in respect of any debt incurred prior to his retirement or death. When a new partner is introduced, the creditors may, by a contract of substituted liability (novation), agree to look to the new partner in place of the old, in which case the latter will be released from his liability to the creditors concerned.

A retired partner may also be held liable for debts contracted after his retirement by reason of the persons subsequently dealing with the firm giving credit on the strength of his supposed continued association with the firm. In order to avoid such liability resulting from being 'held out' as a partner, he must give specific notice of his retirement to all existing creditors, and to all those who have been creditors of the firm and may be such again. He should also give notice of his retirement in the appropriate *Gazette*, and this will operate as notice to the world at large, and will preclude the operation of the doctrine of 'holding out' in favour of any person who might be induced to give credit to the firm on the strength of the supposed partner's financial standing.

The estate of a deceased or bankrupt partner cannot be held liable for debts contracted by the firm after the death, or bankruptcy, as the case may be.

It may not be practicable for the firm to discharge the debt due to a retired partner, or to the deceased partner's estate, out of its existing resources, nor may it be possible for the other partners immediately to bring in additional capital. In such circumstances one of the following methods of settlement may be adopted:

(*a*) Repayment may be made by agreed instalments over a period of years, interest being allowed on the diminishing balance of the amount due.

(*b*) The amount due may be regarded as a loan to the firm to carry the right to either a fixed rate of interest or a share of the profits of the firm.

(*c*) An annuity may be paid to a retired partner for life, or for an agreed number of years, or for the life of some dependant.

(a) Repayment of Outgoing Partner's Capital, etc., by Instalments

Upon the retirement or death of a partner the value of his capital and share of the

goodwill, etc., is ascertained, either in accordance with the provisions of the partnership agreement or by accounts taken at the date of the dissolution, and the amount so ascertained is paid out to him or his representatives forthwith, or credited to a Loan Account, and repaid by instalments, with interest running on the outstanding balance. It is important, where payment is not made at once, that the amount due should be credited to a loan account, and not retained in the books as capital, especially in the case of a retired partner, when retention of the amount due to him as capital might suggest that he was still a partner.

Illustration

M, a partner in a firm, dies on 31st March 19.., and his share of capital and goodwill is ascertained to be £7,600. It is arranged that this shall be paid out by annual instalments of £2,000, to include principal and interest on the outstanding balance at 5 per cent. per annum. The first payment is made one month after death, and succeeding payments are made on the anniversary of the date of death. Show the account in the firm's books relating thereto until completion. Ignore Income Tax.

THE EXECUTORS OF M (DECEASED) LOAN ACCOUNT

		£ s. d.			£ s. d.
19..			19..		
April 30	To Cash ..	2,000 0 0	Mar. 31	By Capital Account	7,600 0 0
	„ Balance c/f ..	5,631 13 4	April 30	„ Interest, 1 month	31 13 4
		£7,631 13 4			£7,631 13 4
19..			19..		
Mar. 31	To Cash ..	2,000 0 0	May 1	By Balance b/f . ..	5,631 13 4
	„ Balance c/f ..	3,889 15 8	19..		
			Mar. 31	„ Interest, 11 months .	258 2 4
		£5,889 15 8			£5,889 15 8
			19..		
Mar. 31	To Cash ..	2,000 0 0	April 1	By Balance b/f .	3,889 15 8
	„ Balance c/f ..	2,084 5 5	19..		
			Mar. 31	„ Interest, 1 year	194 9 9
		£4,084 5 5			£4,084 5 5
19..			19..		
Mar. 31	To Cash ..	2,000 0 0	April 1	By Balance b/f .	2,084 5 5
	„ Balance c/f ..	188 9 8	19..		
			Mar. 31	„ Interest, 1 year	104 4 3
		£2,188 9 8			£2,188 9 8
19..			19..		
Mar. 31	To Cash	197 18 2	April 1	By Balance b/f .	188 9 8
			19..		
			Mar. 31	„ Interest, 1 year	9 8 6
		£197 18 2			£197 18 2

(b) Outgoing Partner's Capital, etc., allowed to remain as a Loan to the firm

Where this course is adopted, the retired partner's capital must be transferred to a Loan Account. Usually the rate of interest payable on this loan and the conditions for repayment are laid down in the partnership agreement or by a contract entered into at the date of retirement, but in the absence of agreement it is provided by Section 42 of the Partnership Act, 1890, that the retired partner is entitled to interest at 5% per annum, or such share of the profits as the court may determine to be attributable to the use of his share of the partnership assets. If a retired partner enforces his right to

a share of profit in these circumstances, the court would deduct a reasonable sum for the services of the remaining partners for carrying on the business, before arriving at the profit to be divided.

Where an option is given to the continuing partners to purchase the share of the retired partner, and the option is exercised, the retired partner is not entitled to any further share of the profits. His capital is, therefore, transferred to the continuing partners, who must pay him according to the terms of the agreement.

When it is agreed that the loan shall carry a rate of interest varying with the profits of the firm or entitle the retired partner to a share of such profits, such an agreement will not of itself cause the retired partner to continue to be liable as a partner of the firm, *provided that the contract is in writing* and signed by or on behalf of all the parties thereto (Section 2, Partnership Act, 1890). If, however, the firm should become bankrupt, the retired partner will be a deferred creditor in respect of any loan made in such circumstances (Section 3, Partnership Act, 1890).

(c) Repayment of Outgoing Partner's Capital, etc., by way of an Annuity

Where a partner retires or dies, the liability of the continuing partners for his capital and share of goodwill, is sometimes discharged by an agreement to pay to him or to his widow, dependants or representatives an annuity, either for a certain term of years or for the lifetime of the retired partner, or his widow, or some named dependants.

In such a case the most convenient method of dealing with the matter in the partnership books is to transfer the amount due to an Annuity Suspense Account, which must be credited with interest at a fixed rate per annum on the diminishing balance, and debited annually with the annuity paid. If the credit balance is exhausted during the lifetime of the annuitant, subsequent instalments of the annuity must be borne by the partners and debited to their Current Accounts (or to Profit and Loss Account before arriving at divisible profits). In the event of the annuitant dying before the credit on the Annuity Suspense Account is exhausted the balance then remaining on the account is a profit to the continuing partners and should be transferred to their Capital Accounts in the proportion in which they share profits. Such a profit will not, normally, be represented by liquid resources available for distribution and, therefore it might be inadvisable to transfer it to Profit and Loss Account or to the partners' Current Accounts.

The balance of the Annuity Suspense Account at the commencement of the transaction and at the date of each balance sheet should, strictly, represent the present worth of the annuity, subject to variation in the expectation of life. An actuarial valuation for the adjustment of the Suspense Account might be made periodically, say every five years, but as with a single annuity there is no scope for the law of average to apply, it is not usual to do this, the simpler procedure outlined above being adopted.

Illustration

A, B and C are partners sharing profits in the ration of 3, 2 and 1. A retires from the firm as from the 31st December 19.., the determined amount of his share being £10,000. It is

agreed that this should be commuted by an annuity of £1,500, the first payment to be made on the following day, and subsequent payments on the 1st January of each year. A dies after the receipt of the fifth annuity payment.

Show the Annuity Suspense Account in the books of the firm, assuming that the amount outstanding is deemed to earn interest at the rate of 6 per cent. Ignore Income Tax.

ANNUITY SUSPENSE ACCOUNT

Date	Particulars	£	s.	d.	Date	Particulars	£	s.	d.
19 . .					19 . .				
Jan. 1	To Cash	1,500	0	0	Jan. 1	By Balance b/f . .	10,000	0	0
Dec. 31	„ Balance c/f	9,010	0	0	Dec. 31	„ Interest (on £8,500)	510	0	0
		£10,510	0	0			£10,510	0	0
19 . .					19 . .				
Jan. 1	To Cash . .	1,500	0	0	Jan. 1	By Balance b/f . .	9,010	0	0
Dec. 31	„ Balance c/f . .	7,960	12	0	Dec. 31	„ Interest (on £7,510)	450	12	0
		£9,460	12	0			£9,460	12	0
19					19 . .				
Jan. 1	To Cash .	1,500	0	0	Jan. 1	By Balance b/f . .	7,960	12	0
Dec. 31	„ Balance c/f	6,848	4	9	Dec. 31	„ Interest (on £6,460 12s. 0d.)	387	12	9
		£8,348	4	9			£8,348	4	9
19					19.				
Jan. 1	To Cash .	1,500		0	Jan. 1	By Balance b/f	6,848	4	9
Dec. 31	„ Balance c/f .	5,669		7	Dec. 31	„ Interest (on £5,348 4s. 9d.)	320	17	10
		£7,169	2	7			£7,169	2	7
19 . .					19.				
Jan. 1	To Cash	1,500	0	0	Jan. 1	By Balance b/f	5,669	2	7
Dec. 31	„ Profit transferred to:								
	B ⅔rds . . £2,779 8								
	C ⅓rd . . 1,389 14								
		4,169	2	7					
		£5,669	2	7			£5,669	2	7

It cannot be assumed that the business would be able to pay the amount of the annuity in all cases out of its liquid resources, as this might result in considerable embarrassment in the course of a few years.

The remaining partners should therefore, if necessary, introduce annually additional capital to the extent of the amount of the annuity less the amount of interest credited to the Annuity Suspense Account for the year. It will be appreciated that the interest credited to the account is not paid to A; it is merely an adjustment to show the true result of the settlement, but as it has been charged to Profit and Loss Account, cash to this extent is retained in the business and it is only necessary for B and C to introduce the balance.

Alternatively, B and C could restrict their drawings each year by the amount required. For example, at the end of the first year the following entry could be made:

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		Dr. £	Cr. £
Current Accounts:			
B	*Dr.*	660	
C		330	
To Capital Accounts:			
B			660
C			330
Transfer from Current Accounts to Capital Accounts of amount necessary to restore the firm's working capital after the payment of annuity of £1,500 to A. B ⅔rd of £(1,500 — 510) = £660. C ⅓rd of £(1,500 — 510) = £330.			

The position is somewhat complicated by the introduction of a new partner. As the business has the benefit of the capital represented by the Annuity Suspense Account, the new partner should bear his share of the interest, which should therefore be debited to Profit and Loss Account. Should the retired partner die before the Annuity Suspense Account is reduced to nil, the credit balance should be divided between the members of the old partnership in the proportions in which they shared profits and losses in the old partnership. If, however, the Annuity Suspense Account is exhausted before the retired partner dies, the subsequent payments should be debited to the Current Accounts of the remaining members of the old partnership in the proportions in which they share profits and losses in the old firm.

(d) Adjustment of values of assets upon change of personnel

When a partner retires, it does not follow that the balance of his Capital Account represents his true interest in the partnership, apart from the question of goodwill, to which reference has already been made, since some assets may have appreciated in value without any adjustment having been made in the books, whilst others may have been insufficiently depreciated, over-depreciated, or entirely written off. It will be necessary, therefore, to correct these values, in order that the outgoing partner shall receive his true share. A Revaluation Account should be opened, to which all differences in values will be debited or credited, the resultant balance being divided among the partners according to the ratio in which they share profits and losses.

Illustration

Brown, Jones and Robinson, sharing profits and losses equally, had been trading for many years, and Robinson decided to retire as at 31st December 19.. on which date the Balance Sheet of the firm was as under:

				£
Capitals:			Freehold Premises	8,000
Brown	10,000		Plant	4,000
Jones	8,000		Patents	6,000
Robinson	6 000		Stock	5,000
		24,000	Debtors	6,000
Creditors		8,000	Cash	3,000
		£32,000		£32,000

The value of the goodwill was agreed at £8,000.

The freehold premises had increased in value as a result of general economic conditions, the value being agreed at £11,000. Plant and patents were respectively revalued at £3,600 and £5,300, and it was also agreed to provide 5% in respect of debtors, it having been the practice in the past only to write off bad debts actually incurred.

Show the adjusted Balance Sheet of the firm, and the amount to which Robinson would be entitled.

REVALUATION ACCOUNT

	£	£		£
To Plant		400	By Goodwill	8,000
" Patents		700	" Freehold Premises	3,000
" Provision for Bad Debts		300		
" Balance transferred to Capital Accounts:				
Brown	3,200			
Jones	3,200			
Robinson	3,200			
		9,600		
		£11,000		£11,000

BALANCE SHEET (AFTER ADJUSTMENT)

	£	£		£	£
Capitals:			Goodwill ..		8,000
Brown	13,200		Freehold Premises		11,000
Jones	11,200		Plant ..		3,600
Robinson	9,200		Patents ..		5,300
		33,600	Stock ..		5,000
Creditors		8,000	Debtors ..	6,000	
			Less Provision for Bad Debts	300	
					5,700
			Cash		3,000
		£41,600			£41,600

Although the above adjustments have been made in order to ascertain the amount due to Robinson, the remaining partners may not desire to disturb the existing book values, in which case the difference on revaluation (£9,600) would be written back to the Capital Accounts of Brown and Jones, in the proportions in which they will share profits and losses in future, the position then being:

				£
Capital Accounts:			Freehold Premises	8,000
Brown £(13,200 — 4,800)	8,400		Plant .	4,000
Jones £(11,200 — 4,800)	6,400		Patents ..	6,000
		14,800	Stock .	5,000
Robinson, Loan Account		9,200	Debtors	6,000
Creditors		8,000	Cash .	3,000
		£32,000		£32 000

Alternatively, the same position could have been achieved by the preparation of a *memorandum* Revaluation Account for the purpose of ascertaining the amount of the net increase in the values of the assets attributable to Robinson, the following entry then being made in the books:

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Capital Accounts:	*Dr.*		
Brown		1,600	
Jones		1,600	
To Capital Account:			
Robinson			3,200
Proportion of net increase in value of assets due to Robinson on retirement, acquired by Brown and Jones.			

In effect Brown and Jones have purchased from Robinson his share of the undisclosed profit represented by the net increase in the value of the assets and are debited with the amount so purchased.

Should a new partner (Smith) be introduced concurrently with Robinson's retirement, he should come in on the basis of the Balance Sheet as adjusted after the revaluation of the assets, or else pay a premium commensurate with his share of goodwill and other net differences. Assuming that no premium is paid, that he introduces £4,000 as capital and that future profits are to be shared in the ratio of: Brown two-fifths, Jones two-fifths, and Smith one-fifth, the initial Balance Sheet will be:

BROWN, JONES AND SMITH
BALANCE SHEET

					£
Capitals:			Goodwill ..		8,000
Brown	13,200		Freehold Premises		11,000
Jones	11,200		Plant ..		3,600
Smith	4,000		Patents ..		5,300
		28,400	Stock ..		5,000
Robinson, Loan Account		9,200	Debtors ..	6,000	
Creditors		8,000	*Less* Provision for Bad Debts	300	
					5,700
			Cash		7,000
		£45,600			£45,600

If the partners now agree that the original book values shall be maintained, the difference (£9,600) must be written off to the Partners' Capital Accounts, in the ratio of 2 : 2 : 1, the new partner being required to participate in the adjustment, since he will be entitled to participate in the proceeds of subsequent realisation when such occurs.

The following will be the final Balance Sheet in such circumstances:

BROWN, JONES AND SMITH
BALANCE SHEET

				£
Capitals:			Freehold Premises	8,000
Brown £(13,200 — 3,840)	9,360		Plant ..	4,000
Jones £(11,200 — 3,840) .	7,360		Patents ..	6,000
Smith £(4,000 — 1,920)	2,080		Stock ..	5,000
		18,800	Debtors ..	6,000
Robinson, Loan Account		9,200	Cash ..	7,000
Creditors		8,000		
		£36,000		£36,000

In any case, arrangements must be made to pay to Robinson the amount due to him, which remains undisturbed by any subsequent adjustments which may be made in the accounts.

§ 7. Sleeping, Quasi and Limited Partners

The term *sleeping partner* is applied to a partner who takes no active part in the business or who has retired from active participation in the business, but retains his capital therein and probably a reduced share of the profits. In such a case no change need be made in the books. Such a partner is sometimes called a *dormant* partner. The Partnership Act does not distinguish between a sleeping partner and an acting partner; the liability of a partner for the firm's debts is the same whether he is dormant or active.

It is very common for a partner to retire and at the same time to take advantage of subsection (3) (*d*) of Section 2 of the Partnership Act, 1890, by leaving his capital in the business in the form of a loan, receiving interest thereon at a rate varying with the profits. In such a case the balance to the credit of his Capital Account should be transferred to a Loan Account, and the interest, based on a proportion of the profits, should be regarded as an expense of the business and debited to Profit and Loss Account. Such an individual, although sometimes termed a *quasi-partner*, is merely a deferred creditor of the firm, his loan not being repayable until after all the other creditors of the firm are paid in full.

The term '*quasi-partner*' is normally applied to a person who, although not a partner, becomes liable as such by 'holding out'. Third parties may become liable for the debts and liabilities of a firm under the operation of this doctrine, which is contained in Section 14 of the Partnership Act. Under that section, where a person has by words spoken or written, or by his conduct represented himself or has knowingly suffered himself to be represented as a partner in a particular firm, and some other person has given credit to the firm on the strength of the supposed association, the person so holding himself out will be liable to the party who has so given credit as if he were actually a partner.

A *limited partnership*, is defined by the Limited Partnerships Act, 1907, as one which must consist of one or more persons called *general* partners, who shall be liable for all the debts and obligations of the firm, and one or more persons, to be called *limited* partners, who shall, at the time of entering into such partnership, contribute thereto a sum or sums as capital or property valued at a stated amount, and who shall not be liable for the debts or obligations of the firm beyond the amount so contributed. A body corporate may be either a general or a limited partner.

Every limited partnership must be duly registered (the registrar being the registrar of companies), otherwise it will be regarded as an ordinary partnership, in which case the limited partner will not secure the protection which he requires. It is therefore incumbent upon the limited partner, in his own interests, to see that registration is duly effected. Registration involves disclosure of particulars as to the firm's name, the general nature of the business, the principal place of business, the full names of each of the partners, the term of the partnership, a statement that the partnership is limited, and the description of every limited partner and the sum contributed by him, and whether paid in cash or otherwise. Any alteration must similarly be registered. Stamp duty is payable upon the capital of a limited partner at the rate of ten shillings per cent., fractions of £100 being counted as £100 (Finance Act, 1933). An advertisement must also be inserted in the *Gazette* if a general partner at any time becomes a limited partner, or if a limited partner assigns his share to another person, who will become a limited partner.

Since a limited partner is placed in a privileged position with regard to his liability, it is only reasonable that he should be subject to certain restrictions as to participation in management, and this is provided for in Section 6 of the Limited Partnerships Act, 1907, as under:

(1) A limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm. A limited partner may, however, by himself or his agent, at any time inspect the books of the firm and examine into the state and prospects of the partnership business, and may advise with the partners thereon.

If a limited partner takes part in the management of the partnership business, he shall be liable for all debts and obligations of the firm incurred while he so takes part in the management, as though he were a general partner.

(2) A limited partnership shall not be dissolved by the death or bankruptcy of a limited partner, and the lunacy of a limited partner shall not be a ground for dissolution of the partnership by the court unless the lunatic's share cannot be otherwise ascertained and realised.

(3) In the event of the dissolution of a limited partnership its affairs shall be wound up by the general partners, unless the court otherwise orders.

(4) Subject to any agreement expressed or implied between the partners—

(*a*) any difference arising as to ordinary matters connected with the partnership business may be decided by a majority of the general partners;

(*b*) a limited partner may, with the consent of the general partner, assign his share in the partnership, and upon such an assignment the assignee shall become a limited partner with all the rights of the assignor;

(*c*) the other partners shall not be entitled to dissolve the partnership by reason of any limited partner suffering his share to be charged for his separate debt;

(*d*) a person may be introduced as a partner without the consent of the existing limited partners;

(*e*) a limited partner shall not be entitled to dissolve the partnership by notice.

As regards the books of the limited partnership, the amount of capital contributed by the limited partner should be placed to the credit of his Capital Account, a note being made in the ledger to the effect that he is a limited partner. Any share of profits or interest on capital to which he may be entitled should be placed to the credit of his Current Account, and not to his Capital Account.

It is important to observe that the Act provides that a limited partner shall not, during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his contribution, and if he does so draw out or receive back any such part he shall be liable for debts and obligations of the firm to the extent of the amount withdrawn.

§ 8. Dissolution of Partnerships

Upon the dissolution of a partnership, Section 44 of the Partnership Act, 1890, provides that the assets of the firm, including the sums (if any) contributed by the partners to make up losses or deficiencies of capital, must be applied in the following manner and order:

(1) In paying the debts and liabilities of the firm to persons who are not partners therein.

(2) In paying to each partner rateably what is due from the firm to him for advances as distinguished from capital.

(3) In paying to each partner the amount due to him in respect of his Capital and Current Account balances.

In the absence of agreement to the contrary the Partnership Act, 1890, provides that the following shall be grounds for the dissolution of a partnership:

(i) The expiration of the term for which the partnership was entered into, if a fixed term was agreed upon.

(ii) The termination of the adventure or undertaking, when a single adventure or undertaking was the purpose of the partnership.

(iii) When one partner gives notice to the others of his intention to dissolve the firm.

(iv) The death of a partner.

(v) The bankruptcy of a partner.

(vi) The happening of an event which causes the partnership to become illegal.

(vii) When a partner allows his share of the partnership to be charged for his separate debt.

In the following cases dissolution may be obtained on application to the court:

(viii) When a partner is found lunatic by inquisition, or in Scotland by cognition, or is shown to the satisfaction of the court to be of permanently unsound mind.

(ix) When a partner, other than the partner suing, becomes in any other way permanently incapable of performing his part of the partnership contract.

(x) When a partner, other than the partner suing, has been guilty of such conduct, as in the opinion of the court, regard being had to the nature of the business, is calculated prejudicially to affect the carrying on of the business.

(xi) When a partner, other than the partner suing, wilfully or persistently commits a breach of the partnership agreement or otherwise so conducts himself in matters relating to the partnership business that it is not reasonably practicable for the other partner or partners to carry on the business in partnership with him.

(xii) When the business of the partnership can only be carried on at a loss.

(xiii) Whenever in any case circumstances have arisen which, in the opinion of the court, render it just and equitable that the partnership be dissolved.

When the partnership agreement contains an arbitration clause, which is a general submission of all matters in difference between the partners, the arbitrator may dissolve the partnership.

The above rules are applicable to limited partnerships in a modified form as explained in § 7.

(a) Formula for closing Partnership Books on Dissolution

Apart from special circumstances, the following outline of the steps necessary to close the books of a partnership when the assets are sold *en bloc*, may be found useful:

(1) Open a Realisation Account, and debit thereto the book value of the assets, crediting the various Asset Accounts. The Realisation Account will also be debited with any expenses of realisation, and cash credited.

(2) Debit cash and credit Realisation Account with the amount realised on the sale of the assets.

Note. Should any of the assets be taken over at a valuation by any of the partners, debit such partners' Capital Accounts, and credit Realisation Account with the agreed price.

(3) Pay off the liabilities, crediting cash and debiting sundry creditors. Any discount allowed by creditors on discharging liabilities should be debited to the creditors' accounts and credited to Realisation Account.

(4) The balance of the Realisation Account will be the amount of the profit or loss on realisation, which will be divided between the partners in the proportion in which they share profits and losses and transferred to their Capital Accounts.

(5) Pay off any partners' advances as distinct from capital, first setting off any *debit* balance on the Capital Account of a partner against his Loan Account.

(6) The balance of the cash book will now be exactly equal to the balances on the Capital Accounts, provided they are in credit; credit cash and debit the partners' Capital Accounts with the amounts paid to them to close their accounts.

Should the Capital Account of any partner be in debit after being debited with his share of the loss, or credited with his share of the profit on realisation, the cash will be insufficient by the amount of such debit balance to pay the other partners the amounts due to them. If the partner whose account is in debit pays to the firm the amount of his indebtedness, the other partners' Capital Accounts can then be closed by the payment of cash. If, however, he is unable to do so the deficiency must, according to the decision in *Garner* v. *Murray*, be borne by the solvent partners, in proportion to their capitals, and not in the proportion in which they share profits and losses. The application of this rule is illustrated on p. 167.

The following illustrations show the closing of the books on the dissolution of partnerships in varying circumstances:

(1) *Where, on dissolution, there is a profit on the realisation of the assets.*

Illustration

X and Y are in partnership sharing profits - five-eighths and three-eighths. They agree to dissolve partnership, and their Balance Sheet at the date of dissolution, 30th June 19.., is as follows:

X AND Y
BALANCE SHEET, 30TH JUNE 19..

Capital Accounts:			Premises	1,200
X	£1,500		Stock	1,400
Y .. .	1,300		Debtors	1,100
		2,800	Cash	600
Creditors ..		1,500		
		£4,300		£4,300

The dissolution is completed by 31st December 19.., the assets, other than cash, being sold *en bloc* and realising £4,500. Close the books of the firm.

REALISATION ACCOUNT

			£				£
June 30	To Sundry Assets		3,700	Dec. 31	By Cash		4,500
Dec. 31	„ Profit transferred to Capital Accounts:						
	X five-eighths	£500					
	Y three-eighths	300					
			800				
			£4,500				£4,500

SUNDRY CREDITORS

						£
Dec. 31	To Cash	1,500	June 30	By Balance b/d.		1,500

X CAPITAL ACCOUNT

		£			£
Dec. 31	To Cash	2,000	June 30	By Balance b/d. ..	1,500
			Dec. 31	„ Realisation Account: Profit	500
		£2,000			£2,000

Y CAPITAL ACCOUNT

		£				£
Dec. 31	To Cash	1,600	June 30	By Balance b/d. ..		1,300
			Dec. 31	„ Realisation Account: Profit		300
		£1,600				£1,600

CASH

		£				£
June 30	To Balance b/d. ..	600	Dec. 31	By Creditors ..		1,500
Dec. 31	„ Realisation Account	4,500		„ Capital Accounts:		
				X ..	£2,000	
				Y ..	1,600	
						3,600
		£5,100				£5,100

(2) *Where, on dissolution, the liabilities are paid in full, but there is a loss on the realisation of the assets.*

Illustration

D, E and F, sharing profits and losses, one-half, one-third, and one-sixth respectively, dissolve partnership. At the date of dissolution their creditors amount to £2,300, and in the course of winding-up a contingent liability of £200, not brought into the accounts, matured and had to be met The capitals stood at £6,000, £4,000 and £1,500, respectively. D had lent to the firm as distinct from capital £2,000. The assets realised £10,000. Close the books of the firm.

REALISATION ACCOUNT

	£			£
To Sundry Assets ..	15,800	By Cash ..		10,000
„ Contingent liability matured	200	„ Loss transferred to Capital Accounts		
		D one-half . ..	£3,000	
		E one-third	2,000	
		F one-sixth	1,000	
				6,000
	£16,000			£16,000

SUNDRY CREDITORS

	£		£
To Cash	2,500	By Balance b/d. .	2,300
		„ Realisation Account:	
		Contingent liability matured	200
	£2,500		£2,500

D LOAN ACCOUNT

	£		£
To Cash	2,000	By Balance b/d	2,000

D CAPITAL ACCOUNT

	£		£
To Realisation Account: Loss	3,000	By Balance b/d.	6,000
„ Cash	3,000		
	£6,000		£6,000

E CAPITAL ACCOUNT

	£		£
To Realisation Account: Loss	2,000	By Balance b/d.	4,000
„ Cash	2,000		
	£4,000		£4,000

F CAPITAL ACCOUNT

	£		£
To Realisation Account: Loss	1,000	By Balance b/d. ..	1,500
„ Cash	500		
	£1,500		£1,500

CASH

	£		£
To Realisation Account	10,000	By Creditors .	2,500
		„ D Loan Account .	2,000
		„ D Capital Account	3,000
		„ E „ „	2,000
		„ F „ „ .	500
	£10,000		£10,000

Note

The book value of the assets is equal to the sum of the capitals plus the creditors, *viz.*, £6,000 + £4,000 + £1,500 + £2,300 + £2,000 – £15,800.

(3) *Where, on dissolution, there is a loss on the realisation of the assets, placing one partner's Capital Account in debit, which amount he pays into the firm's account in cash.*

Illustration (1)

J and P are in partnership, with capitals of £700 and £100. The creditors are £2,300. The assets realise £1,900. Partners share profits and losses equally. Close the books of the firm, P having brought in the amount due by him.

REALISATION ACCOUNT

	£		£
To Sundry Assets	3,100	By Cash	1,900
		„ Loss to Capital Accounts:	
		J one-half ..	600
		P one-half ..	600
	£3,100		£3,100

J CAPITAL ACCOUNT

	£		£
To Realisation Account: Loss	600	By Balance b/d.	700
„ Cash	100		
	£700		£700

P CAPITAL ACCOUNT

	£		£
To Realisation Account: Loss	600	By Balance b/d.	100
		„ Cash ..	500
	£600		£600

CREDITORS

	£		£
To Cash	2,300	By Balance b/d.	2,300

CASH

	£		£
To Realisation Account	1,900	By Creditors ..	2,300
„ P Capital Account ..	500	„ J Capital Account	100
	£2,400		£2,400

Where, on dissolution, the assets are not sold *en bloc*, but are realised separately; or certain assets are taken over by partners on account of the sums due to them, it may be preferable, instead of transferring all the assets to a Realization Account and crediting that account with the total proceeds, to credit each separate asset account with the amount at which it is sold or taken over, transferring the resultant profit or loss to a Realization Profit and Loss Account, the ultimate balance of which will represent the net profit or loss on the dissolution.

Illustration (2)

G and T, having carried on business as drapers and household furnishers at the same premises for a number of years, share profits and losses equally, decide to dissolve partnership.

At the date of dissolution their balance sheet was as follows:

	£	£		£	£
Capital Accounts:			Goodwill . .		1,000
G ..	7,000		Freehold Premises		8,000
T .	8,000		Fixtures:		
		15,000	Drapery Department	750	
Sundry Creditors		3,200	Furnishing Department	400	
					1,150
			Sundry Debtors		1,050
			Stock:		
			Drapery Department .. .	1,600	
			Furnishing Department . ..	1,400	
					3,000
			Cash at Bank		4,000
		£18,200			£18,200

The agreed terms were:

G was to take over the premises at £7,000, the drapery stock at £1,700, and drapery fixtures at £500.

T, having rented another shop nearby, was to take over the furniture stock at £1,500 and the fixtures of that department at £300.

Goodwill was to be written off.

Any loss on debtors was to be shared as to G three-fifths, and T two-fifths.

The creditors were to be paid by G.

The debtors realised £950, the proceeds being retained by G.

Prepare accounts, showing the final settlement between the partners.

REALISATION PROFIT AND LOSS ACCOUNT

		£			£
To Goodwill written off		1,000	By Profit on transfer of Stock .. .		200
,, Bad Debts		100	,, Loss on Debtors shared by agreement:		
,, Loss on transfer of:			G, three-fifths	60	
Freehold Premises	1,000		T, two-fifths .	40	
Fixtures	350				100
		1,350	,, Loss on Realisation of other Assets:		
			G, Capital Account .. .	1,075	
			T, ,, ,, .. .	1,075	
					2,150
		£2,450			£2,450

CASH ACCOUNT

	£		£
To Balance	4,000	By T, Capital Account	5,085
,, G, Capital Account	1,085		
	£5,085		£5,085

DEBTORS

			£
To Balance	1,050	By G, Proceeds of Realisation ..	950
		,, Realisation Profit and Loss Account	100
	£1,050		£1,050

FREEHOLD PREMISES

			£
To Balance, b/f	8,000	By G, Capital Account ..	7,000
		,, Realisation Profit and Loss Account	1,000
	£8,000		£8,000

FIXTURES

			£
To Balance, b/f..			
Drapery	750	By G, Capital Account ..	500
Furnishings	400	,, T, Capital Account .	300
		,, Realisation Profit and Loss Account	350
	£1,150		£1,150

STOCK

	£		£
To Balance, b/f.		By G, Capital Account	1,700
Drapery .	1,600	,, T. ,, ,, .	1,500
Furnishing . ..	1,400		
,, Realisation Profit and Loss Account	200		
	£3,200		£3,200

CAPITAL ACCOUNTS

	G	T		G	T
	£	£		£	£
To Freehold Premises	7,000		By Balance, b/f.	7,000	8,000
,, Stock	1,700	1,500	,, Creditors taken over	3,200	
,, Fixtures	500	300	,, Cash .. .	1,085	
,, Debtors	950				
,, Bad Debts	60	40			
,, Profit and Loss on Realisation ..	1,075	1,075			
,, Cash		5,085			
	£11,285	£8,000		£11,285	£8,000

(4) *Where, on dissolution, a partner's Capital Account is in debit, and he is unable to discharge his indebtedness, so that the rule in* Garner *v.* Murray *must be applied.*

Prior to the decision in *Garner* v. *Murray* it was generally supposed that any loss occasioned by one of the partners of a firm being unable to make good a debit balance on his account should be borne by the remaining partners in the proportions in which they shared profits and losses.

In this case, however, it was held that a deficiency of assets occasioned through the default of one of the partners must be distinguished from an ordinary trading loss, and should be regarded as a debt due to the remaining partners individually, and not to the firm.

The circumstances of the case, the decision in which gave rise to considerable controversy, were as follows: Garner, Murray and Wilkins were in partnership under a parol agreement by the terms of which capital was to be contributed by them in unequal shares, but profits and losses were to be divided equally. On the dissolution of the partnership, after payment of the creditors and of advances made by two of the partners, there was a deficiency of assets of £635, in addition to which Wilkins' Capital Account was overdrawn by £263, which he was unable to pay. There was thus a total deficiency of £898, and the plaintiff claimed that this should be borne by the solvent partners, Garner and Murray, in their agreed profit-sharing ratio, *viz.* equally. Mr. Justice Joyce held, however, that each of the three partners was liable to make good his share of the £635 deficiency of assets, after which the available assets should be applied in repaying to each partner what was due to him on account of capital. Since, however, one of the 'assets' was the debit balance on Wilkins' account, which was valueless, the remaining assets were to be applied in paying to Garner and Murray rateably what was due to them in respect of capital, with the result that Wilkins' deficiency was borne by them in proportion to their capitals.

The effect of the decision is shown in the following illustration.

Illustration

A, B and C with unequal capitals, share profits and losses equally. They decide to dissolve partnership, and the following Balance Sheet shows the position of affairs after the assets have been realised and the liabilities discharged.

BALANCE SHEET

			£
Capitals:		Cash ..	500
A ..	600	Capital C overdrawn	200
B ..	400	Deficiency of Assets	300
	£1,000		£1,000

C is insolvent and is unable to contribute anything towards either his overdraft on Capital or his share of the loss on realisation.

The loss on realisation of £300 should first be debited in profit-sharing ratio to the partners' accounts, thus reducing A's capital to £500 and B's to £300, and increasing C's deficit to £300.

If the ruling in *Garner* v. *Murray* were followed strictly, A and B would introduce cash of £100 each to make good their shares of the deficiency and thus restore their capitals to £600 and £400 respectively. The balances then remaining in the books would be as shown by the reconstructed Balance Sheet given below.

BALANCE SHEET

	£		£
Capitals:		Cash	700
A ..	600	C's Capital overdrawn ..	300
B ..	400		
	£1,000		£1,000

The only true asset, *viz.*, cash of £700, would now be divided between the solvent partners, A and B, in proportion to their capitals, *viz.*:

	£
A $\frac{6}{10}$ths of £700	420
B $\frac{4}{10}$ths of £700	280
	£700

The only balances then remaining in the books would be the debit balance on C's Capital Account, £300, and the credit balances on the Capital Accounts of A and B, £180 and £120 respectively. As C is insolvent, the debit balance on his account will be written off against A and B, in the ratio of their respective capitals, *viz.* £180 to A and £120 to B, thus closing their accounts.

As has been shown the net effect of the above treatment is to cause A and B to bear C's deficiency in proportion to their respective capitals. The introduction of cash by A and B to meet their share of the loss on realisation is unnecessary, as the balances on their Capital Account are sufficient to meet this loss. C's deficiency should be written off against the Capital Account of A and B in *capital* ratio, *viz.* 6 : 4, after which the cash in hand will be exactly sufficient to repay to A and B the balances due to them on Capital Account, as shown hereunder.

CAPITAL ACCOUNTS

	A £	B £	C £		A £	B £	C £
To Balance b/d.			200	By Balance b/d.	600	400	
,, Realisation Account – Loss	100	100	100	,, A and B – C's deficiency transferred:			
,, C	180	120		A six-tenths			180
,, Cash	320	180		B four-tenths			120
	£600	£400	£300		£600	£400	£300

(5) *Piecemeal Realisation and Interim Distributions*

When assets are realised piecemeal, the partners may desire, as soon as all liabilities have been discharged, to withdraw immediately such cash as is available for division between them rather than wait until all the assets have been sold. In such circumstances the interim payments to the partners should be of such amounts that even though the remaining assets prove to be worthless no partner will have received more

than the amount to which he is ultimately found to be entitled after being debited with his proper share of the total loss sustained on realisation of all the assets.

Illustration (1)

A, B, C and D are in partnership, sharing profits in the ratio 3 : 2 : 1 : 4. It is decided to dissolve the firm on 1st January 19.., on which date the Balance Sheet was as under:

BALANCE SHEET, AS AT 1ST JANUARY 19..

		£		£
Capital Accounts:			Goodwill	3,000
A	£7,000		Land and Buildings	8,500
B	4,000		Plant and Machinery	7,921
C	3,000		Investments	2,000
D	4,000		Stock-in-trade	6,348
		18,000	Sundry Debtors	3,841
Sundry Creditors		6,923	Cash at Bank	313
Leasehold Redemption Fund		2,000		
General Reserve		5,000		
		£31,923		£31,923

The assets are realised piecemeal as under:

			£
January	10	Stock (part) ..	3,500
,,	14	Debtors (part)	2,932
,,	28	Investments ..	2,420
February	3	Goodwill ..	2,000
,,	21	Land and Buildings	7,000
		Debtors (part)	500
		Stock (balance)	2,750
March	15	Plant and Machinery	6,560
		Debtors (balance)	351

Subject to reserving £500 to meet the probable expenses of realisation, the partners decide that after the creditors have been paid, all cash received shall be divided between them immediately.

The expenses of realisation, which are paid on 15th March, amount to £400.

Prepare a Statement showing how the distributions should be made, and show the Realisation Profit and Loss Account, Cash Account and partners' Capital Accounts. Calculations are to be made to the nearest £.

After transferring the General Reserve to the partners' Capital Accounts in profit-sharing ratio the capitals of the partners will be:

	A	B	C	D	Total
	£	£	£	£	£
Balance, 1st January	7,000	4,000	3,000	4,000	18,000
General Reserve	1,500	1,000	500	2,000	5,000
	£8,500	£5,000	£3,500	£6,000	£23,000
The profit-sharing ratio is	3		1	4	10

It is apparent that D has the smallest capital in relation to his share of profit, *viz.*, £6,000 ÷ 4 = £1,500 capital per unit of profit. If the capitals of the other partners were held on the same basis, A's capital would be £4,500, B's £3,000 and C's £1,500. A, B and C, therefore, have surplus capital over that of D, as under, which surplus must be repaid to them before any payments are made to D.

	A	B	C	D	Total
	£	£	£	£	£
Balances as above	8,500	5,000	3,500	6,000	23,000
Capitals in profit-sharing ratio ..	4,500	3,000	1,500	6,000	15,000
Surplus Capitals	£4,000	£2,000	£2,000		£8,000

As between A, B and C the profit-sharing ratio is as 3 : 2 : 1 and it is obvious, therefore, that of these three B has the smallest surplus capital in relation to his share of profit. If B's surplus capital of £2,000 were in the same proportion to the total surplus capital as his share of profit, the total surplus capital would be £6,000, of which A's share would be £3,000, B's £2,000 and C's £1,000. A and C therefore have surplus capital over B, as under, which must be repaid to them before any payment is made to B.

	A	B	C	D	Total
	£	£	£	£	£
Surplus Capital as above ..	4,000	2,000	2,000	—	8,000
Surplus Capitals in profit-sharing ratio	3,000	2,000	1,000		6,000
Further Surplus Capital ..	£1,000		£1,000		£2,000

As between A and C the profit-sharing ratio is as 3 : 1 and A therefore has the smaller surplus capital in relation to his share of profit. If A's surplus of £1,000 represented three-fourths of the total surplus, this would be £1,333. C, therefore has a further surplus over A of £667 as shown hereunder.

	A	B	C	D	Total
	£	£	£	£	£
Surplus Capital as above ..	1,000	—	1,000	—	2,000
Surplus Capital in profit-sharing ratio	1,000	—	333	—	1,333
Ultimate Surplus Capital			£667		£667

The amounts becoming available for distribution should accordingly be paid to the partners in the order of priority shown in the following statement.

	A	B	C	D	Total
	£	£	£	£	£
The first £667			667		667
The next £1,333	1,000		333		1,333
	1,000		1,000		2,000
The next £6,000	3,000	2,000	1,000		6,000
	£4,000	£2,000	£2,000		£8,000

After repayment of the above £8,000, the balances remaining on the Capital Accounts will be A £4,500, B £3,000, C £1,500 and D £6,000, these amounts being in the same proportion as that in which profits and losses are shared. By dividing all further realisations in profit-sharing ratio, therefore, each partner will receive his proper share of the profit or bear his proper share of the loss.

STATEMENT OF ACTUAL DISTRIBUTIONS

19 .		Cash available	A	B	C	D	Total
		£	£	£	£	£	£
	Balance b/f.	313					
Jan 10	Realisation	3,500					
14	"	2,932					
28	" .. .	2,420					
		9,165					
	Less Creditors .	6,923					
Jan 28		2,242					
	Less Reserved for Expenses	500					
		1,742					
	Less to C	667	—	..	667	—	667
	Divisible between A and C in proportion of 1,000: 333.	£1,075	806	—	269	—	1,075
			£806	£—	£936	£—	£1,742
19.. Feb 3	Realisations	2,000					
	Less Balance of £1,333 to A and C in proportion of 1,000 : 333	258	194	-	64	—	258
	Divisible between A, B and C in proportion of 3,000; 2,000; 1,000.	£1,742	871	581	290	—	1,742
			£1,065	£581	£354	£—	£2,000
19 . Feb 21	Realisations	10,250					
	Less Balance of £6,000 to A ,B and C in proportion of 3,000 : 2,000 : 1,000 ..	4,258	2,129	1,419	710	—	4,258
	Divisible between A, B and C and D in profit-sharing ratio of 3 : 2 : 1 : 4.	£5,992	1,798	1,198	599	2,397	5,992
			£3,927	£2,617	£1,309	£2,397	£10,250
19 . Mar 15	Realisations	6,911					
	Add amount reserved for expenses no longer required	100					
	Divisible between A, B, C and D in profit-sharing ratio 3 : 2 : 1 : 4	£7,011	£2,103	£1,403	£701	£2,804	£7,011

The accounts will be closed as follows:

CASH ACCOUNT

		£			£
Jan. 1	To Balance b/d. ..	313	Jan. 28	By Sundry Creditors . .	6,923
10	„ Stock Account ..	3,500		„ Capital Accounts:	
14	„ Sundry Debtors	2,932		A .. .	806
28	„ Investments ..	2,420		C . .	936
Feb. 3	„ Goodwill ..	2,000	Feb. 3	„ Capital Accounts:	
21	„ Land and Buildings	7,000		A	1 065
	„ Sundry Debtors ..	500		B	581
	„ Stock ..	2,750		C . . .	354
Mar. 15	„ Plant and Machinery	6,560	21	„ Capital Accounts:	
	„ Sundry Debtors .	351		A	3,927
				B . . .	2,617
				C	1,309
				D	2 397
			Mar 15	„ Realisation Profit and Loss Account: Expenses	400
				„ Capital Accounts:	
				A	2,103
				B	1,403
				C	701
				D	2 804
		£28,326			£28,326

REALISATION PROFIT AND LOSS ACCOUNT

			£				£
Feb. 3	To Goodwill		1,000	Jan. 28	By Investments		420
21	,, Land and Buildings		1,500	Feb. 21	,, Leasehold Redemption Fund		2,000
	,, Stock		98	Mar. 15	,, Loss transferred to Capital Accounts:		
	,, Plant and Machinery		1,361		A 3/10ths	£599	
	,, Sundry Debtors		58		B 2/10ths	399	
	,, Cash – Expenses of Realisation		400		C 1/10th	200	
					D 4/10ths	799	
							1,997
			£4,417				£4,417

CAPITAL ACCOUNTS

		A	B	C	D			A	B	C	D
		£	£	£	£			£	£	£	£
Jan. 28	To Cash	806	—	936	--	Jan. 1	By Balances b/d.	7,000	4,000	3,000	4,000
Feb. 3	,, ,,	1,065	581	354	--		,, General Reserve	1,500	1,000	500	2,000
21	,, ,,	3,927	2,617	1,309	2,397						
Mar. 15	,, Loss on Realisation	599	399	200	799						
	,, Cash	2,103	1,403	701	2,804						
	£	8,500	5,000	3,500	6,000		£	8,500	5,000	3,500	6,000

Another, and more cautious method, is to treat the assets remaining unrealised after each realisation as valueless, and to charge each partner with his share of the notional loss according to the agreed profit-sharing ratio. If a partner's capital is thereby thrown into debit, the amount thereof should be charged to the other partners in proportion to their capitals, in accordance with the rule in *Garner* v. *Murray*. The aggregate of the balances of the partners' Capital Accounts, after deducting the amounts of any previous distributions, will then equal the sum available for distribution. This process will be repeated on each realisation, with the result that after the final distribution, each partner will have borne his proper share of the ultimate loss.

Illustration (4)

A, B and C share profits in the proportion of $\frac{1}{2}$, $\frac{1}{3}$ and $\frac{1}{6}$. Their Balance Sheet is as follows:

	£		£
A Capital Account	3,000	Assets, *less* liabilities	8,000
B Capital Account	3,000		
C Capital Account	2,000		
	£8,000		£8,000

The partnership is dissolved, and the assets are realised as follows:

	£
First realisation	1,000
Second realisation	1,500
Third and final realisation	2,500
	£5,000

		A	B	C	Total Distributions
	£	£	£	£	£
Capitals		3,000	3,000	2,000	
First Realisation	1,000				
Balance of assets treated as loss	7,000	($\frac{1}{2}$) 3,500	($\frac{1}{3}$) 2,333	($\frac{1}{6}$) 1,167	
	£8,000	*Dr.* £500	c/f 667	833	

	£	A £	B £	C £	Total Distribution £
Brought forward			667	833	
A's debit balance divided between B and C in *capital* ratio (*Garner* v. *Murray*)			($\frac{3}{5}$) 300	($\frac{2}{5}$) 200	
Distribution of First Realisation ..			£367	£633	1,000

	£	£	£	£	
Capitals		3,000	3,000	2,000	
Second Realisation ..	1,500				
Balance of assets treated as loss	5,500	($\frac{1}{2}$) 2,750	($\frac{1}{3}$) 1,833	($\frac{1}{6}$) 917	
	£7,000	250	1,167	1,083	
Less First Distribution ..		—	367	633	
Distribution of Second Realisation		£250	£800	£450	1,500

	£	£	£	£	
Capitals		3,000	3,000	2,000	
Final Realisation	2,500				
Balance of assets, being ultimate loss	3,000	($\frac{1}{2}$) 1,500	($\frac{1}{3}$) 1,000	($\frac{1}{6}$) 500	
	£5,500	1,500	2,000	1,500	
Less First and Second Distributions		250	1,167	1,083	
Distribution of Final Realisation ..		£1,250	£833	£417	2,500

The ultimate loss of £3,000 has thus been borne by the partners in the correct proportions.

The accounts will be closed as follows:

REALISATION ACCOUNT

	£			£
To Net Assets	8,000	By Cash:		
		1st Realisation		1,000
		2nd "		1,500
		3rd "		2,500
		" Loss transferred to Capital Accounts:		
		A $\frac{1}{2}$ ..	£1,500	
		B $\frac{1}{3}$ ..	1,000	
		C $\frac{1}{6}$ ..	500	
				3,000
	£8,000			£8,000

CASH ACCOUNT

To 1st Realisation	1,000	By Capital Accounts:	
		B	367
		C	633
" 2nd Realisation	1,500	" Capital Accounts:	
		A	250
		B	800
		C	450
" 3rd Realisation	2,500	" Capital Accounts:	
		A	1,250
		B	833
		C	417

CAPITAL ACCOUNTS

	A	B	C		A	B	C
	£	£	£		£	£	£
To Cash 1st Realisation		367	633	By Balances b/f.	3,000	3,000	2,000
" " 2nd "	250	800	450				
" " 3rd "	1,250	833	417				
" Realisation Account: Loss	1,500	1,000	500				
	£3,000	£3,000	£2,000		£3,000	£3,000	£2,000

The basis of distribution adopted may, of course, be different from either of the above methods if the partners so agree.

(b) Dissolution of Partnership by death or bankruptcy

Under Section 33 of the Partnership Act, 1890, any partnership, except where otherwise agreed, is dissolved as regards all the partners by the death or bankruptcy of any partner.

Section 42 of the Act provides that where any member has died, or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with its capital or assets, without any final settlement of accounts as between the firm and the outgoing partner or his estate, the outgoing partner or his estate is, in the absence of agreement, entitled to such share of the profits made since the dissolution as the court may find to be attributable to the use of his share of the partnership assets, or to interest at 5 per cent. per annum on the amount of his share of the partnership assets.

Illustration

F, G and H are partners in a manufacturing business. F is entitled to one-fourth of the partnership profits, G to one-eighth, and H to five-eighths. The yearly accounts are made up to 30th September.

F became bankrupt on the 31st March, 1958, and G and H continued the business without paying out F's share of the partnership assets, or settling accounts with his trustee, until the close of the year – 30th September, 1958,

The Balance Sheet at 30th September, 1957, showed F's capital to be £4,000.

The partners' drawings during the year to 30th September, 1958, have been as follows: F £250, G £100, and H £700.

There is no agreement for interest on capital, but the partners F and G are each to be

credited with a salary at the rate of £100 per annum. Subject to this charge, the profits for the year ended 30th September, 1958, are £1,750, which may be assumed to have accrued evenly throughout the year.

Show the balance of profits and salary due to each partner, and the total amount due by G and H to F's Estate at 30th September, 1958, assuming that F's trustee does not propose to apply to the court for a share of profits.

F, G and H PROFIT AND LOSS ACCOUNT
For the Six Months ended 31st March, 1958

	£	£		£
To Partners' Salaries:			By Profit for 6 months to date (½ × £1,750)	875
F ..	50			
G ..	50			
		100		
„ Balance c/d.		775		
		£875		£875
To F one-fourth		194	By Balance b/d	775
„ G one-eighth		97		
„ H five-eighths		484		
		£775		£775

G and H PROFIT AND LOSS ACCOUNT
For the Six Months ended 30th September, 1958

			£
To Partner's Salary:		By Profit for 6 months to date (½ × £1,750)	875
G	50		
„ Interest: F			
5% per annum on £3,994, balance of Capital and Current Accounts	100		
„ Balance c/d.	725		
	£875		£875
To G one-sixth	121	By Balance b/d	725
„ H five-sixths	604		
			£725

F CURRENT ACCOUNT

	£		£
To Drawings ..	250	By Salary to 31st March	50
		„ Profit „ „	194
		„ Balance to Capital Account	6
	£250		£250

F CAPITAL ACCOUNT

	£		£
To Current Account	6	By Balance b/d.	4,000
„ Balance c/d. ..	4,094	„ Interest to 30th September 6 months at 5% per annum	100
	£4,100		£4,100
		By Balance, being total amount due to F's Estate b/d.	4,094

G CURRENT ACCOUNT

	£		£
To Drawings ..	100	By Salary – F, G and H	50
„ Balance c/d.	218	„ Profit	97
		„ Salary – G and H ..	50
		„ Profit	121
	£318		£318
		By Balance b/d.	218

H CURRENT ACCOUNT

	£		£
To Drawings	700	By Profit – F, G and H	484
„ Balance c/d.	388	„ „ G and H ..	604
	£1,088		£1,088
		By Balance b/d.	388

Note
If F's trustee applied to the court for a share of the profits, the latter would probably direct that the profits should be charged with reasonable salaries for the services of the continuing partners, before arriving at the balance of which F was entitled to a share.

(c) Amalgamation of Firms

Where the members of two or more partnerships decide to amalgamate, the transaction resolves itself into the dissolution of the existing partnerships and the formation of a new one. For the purposes of the amalgamation it is probable that the goodwill and other assets of the original firms will be revalued, and the capitals of the respective partners adjusted by reference to the profit or loss arising on such revaluation, before arriving at the amount of capital introduced by each partner into the new firm. Where the capital of the new firm is a fixed amount, to be provided by the partners in specified proportions or sums, it may be necessary, after giving effect to the agreed revaluations of assets, for cash to be withdrawn or paid in by one or more of the partners in order to adjust the capitals to the agreed amounts.

Illustration

Black and Green and Brown and Grey are two partnerships carrying on a similar type of business. They agree to amalgamate the two businesses as on 1st January, 1959, under the name of Tints & Co. Black and Green share profits in the ratio 8 : 7 and Brown and Grey 3 : 2. The respective Balance Sheets at 31st December, 1958, were as under:

	Black and Green £	Brown and Grey £
Trade and Expense Creditors	6,400	5,600
Current Accounts:		
Black	1,000	
Green .. .	600	
Capital Accounts:		
Black	12,000	
Green	10,500	
Brown		11,000
Grey		7,800
	£30,500	£24,400

	Black and Green £	Brown and Grey £
Balance at Bank	4,200	3,100
Investments	1,500	—
Debtors	7,100	6,500
Stock	5,900	6,700
Vehicles	2,500	1,700
Fixtures	1,800	1,400
Freeholds .	7,500	5,000
	£30,500	£24,400

The amalgamation agreement contained the following provisions:

(1) The freeholds and fixtures of Brown and Grey to be sold - these assets were sold for £10,000 and the sale was completed on 1st January, 1959.

(2) Assets to be revalued as under:

	Black and Green £	Brown and Grey £
Stock	5,700	6,200
Vehicles	2,300	1,500
Fixtures	2,000	·
Freeholds	9,500	—

(3) Provision to be made for doubtful debts of £400 by Black and Green, and of £500 by Brown and Grey; the creditors of each firm to be subject to a discount of 2½ per cent.

(4) Black to take over his firm's investments at £1,200.

(5) The goodwill of Black and Green is to be taken at £7,500, and that of Brown and Grey at £5,000.

(6) Profits in the new firm are to be shared in the proportion of six-twentieths to Black, five-twentieths each to Green and Brown and four-twentieths to Grey.

(7) The capital of the new firm is to be £50,000, to be provided by the partners in their profit-sharing ratios, adjustments to be made in cash.

Close the books of Black and Green and of Brown and Grey, and show the opening balance sheet of of Tints & Co.

BLACK AND GREEN'S BOOKS

REALISATION ACCOUNT

		£		£	£
To Sundry Assets		30,500	By Black – Investments . .		1,200
,, Provision for Doubtful Debts ..		400	,, Provision for Discount on Creditors ..		160
,, Capital Accounts – Profit on Realisation:			,, Tints & Co : Assets taken over:		
Black 8/15ths	4,672		Goodwill	7,500	
Green 7/15ths	4,088		Freeholds	9,500	
		8,760	Fixtures	2,000	
			Vehicles	2,300	
			Stock	5,700	
			Debtors ..	7,100	
			Bank Balance .	4,200	
					38,300
		£39,660			£39,660

CAPITAL ACCOUNTS

	Black £	Green £		Black £	Green £
To Investments ..	1,200		By Balances, b/f. .. .	12,000	10,500
,, Capital in Tints & Co.	15,000	12,500	,, Current Accounts	1,000	600
,, Cash from Tints & Co.	1,472	2,688	,, Realisation Account – Profit	4,672	4,088
	£17,672	£15,188		£17,672	£15,188

TINTS & CO.

	£		Black	Green	£
To Sundry Assets	38,300	By Sundry Creditors . .			6,400
„ Provision for Discounts on Creditors	160	, Provision for Doubtful Debts			400
			Black £	Green £	
		„ Capital Accounts:			
		Capital in Tints & Co	15,000	12,500	
		Cash .	1,472	2,688	
					31,660
	£38,460				£38,460

BROWN AND GREY'S BOOKS
REALISATION ACCOUNT

	£			
To Sundry Assets	24,400	By Discount on Creditors . . .		—
„ Provision for Doubtful Debts	500	„ Tints & Co. – Assets transferred.		
„ Profit on Realisation:		Goodwill	5,000	
Brown 3/5ths .	4,524	Vehicles . . .	1,500	
Grey 2/5ths .	3,016	Stock . . .	6,200	
		Debtors	6,500	
		Bank Balance . .	13,100	
		(including £10,000 proceeds of Freeholds, etc.)		32,300
	£32,440			£32,440

CAPITAL ACCOUNTS

	Brown £	Grey £		Brown £	Grey £
To Capital in Tints & Co	12,500	10,000	By Balance, b/f.	11,000	7,800
„ Cash from Tints & Co	3,024	816	„ Realisation Account	4,524	3,016
	£15,524	£10,816		£15,524	£10,816

TINTS & CO.

	£		Brown	Grey	£
To Realisation Account - Sundry Assets	32,300	By Creditors taken over .			5,600
„ Provision for Discounts on Creditors	140	„ Provision for Doubtful Debts			500
			Brown £	Grey £	
		„ Capital Accounts:			
		Capital in Tints & Co .	12,500	10,000	
		Cash . .	3,024	816	
	£32,440				

TINTS & CO.
BALANCE SHEET as at 1st January, 1959

	£	£				£
Partners' Capital.			Fixed Assets, at cost.			
Black	15,000		Goodwill . .		12,500	
Green	12,500		Freeholds . .		9,500	
Brown .	12,500		Fixtures		2,000	
Grey	10,000		Vehicles		3,800	
		50,000				27,800
Trade and Expense Creditors . .	12,000		Current Assets:			
Less Provision for Discounts	300		Stock		11,900	
		11,700	Debtors	£13,600		
			Less Provision for Doubtful Debts	900		
					12,700	
			Bank Balance		9,300	
						33,900
		£61,700				£61,700

Note.
The Bank balance of Tints & Co. is made up as follows:

			£
Taken over from: Black and Green	..		4,200
Brown and Grey	..		13,100
		£	17,300
Less Paid to: Black	.. ..	1,472	
Green	.. .	2,688	
Brown	.. ..	3,024	
Grey ..	.. ..	816	
			8,000
			£9,300

(d) The Conversion of a Private Firm into a Limited Company

Frequently a private business is 'converted' into a limited company, *i.e.* transferred to the company in exchange for shares therein. The company may be either a private one, in which case the shares will be held by the families concerned, or a public company, the shares or debentures of which may be offered for subscription to the public.

The advantages of such a 'conversion' are set out in Section 1 of Chapter VIII.

Such a transaction will necessitate the books of the firm being closed, and new books being opened for the company. The following will be the procedure for closing the firm's books:

(1) Open a Realisation Account, and transfer to the debit thereof the book value of the assets taken over by the purchasing company, crediting the various asset accounts.

(2) Transfer to the credit of Realisation Account the liabilities assumed by the company, debiting the respective liability accounts.

(3) Debit the Purchasing Company's Account, and credit Realisation Account with the agreed purchase price of the net assets taken over by the company.

Note. The term 'net assets' means the assets less the liabilities.

(4) The balance on the Realisation Account, after debiting expenses (if any), will represent the profit or loss on realisation of the net assets, and will be divided between the partners in the proportions in which they share profits and losses.

(5) Debit the accounts of the assets (*e.g.* cash, shares, debentures, etc.) received as purchase consideration, and credit the Purchasing Company's Account.

(6) Pay off any liabilities not taken over by the new company, crediting cash and debiting the liability accounts.

(7) Distribute between the partners the shares, debentures, etc., received from the company in the proportions agreed between them, debiting their Capital Accounts and crediting the accounts of the shares, debentures, etc.

(8) Any balances remaining on Capital Accounts must now be cleared by the withdrawal or payment in of cash.

Illustration

The firm of J, S and R decide to turn their business into a limited company, J. S. & R. Ltd. Their Balance Sheet is as follows:

J, S AND R
BALANCE SHEET, 30TH JUNE

		£			£
Capital Accounts:			Freehold Property		30,000
J	£25,000		Plant		10,900
S	15,000		Fixtures, Fittings and Furniture		1,500
R	10,000		Stock-in-Trade		19,500
		50,000	Sundry Debtors	£68,830	
			Less Provision	2,000	
Trade Creditors		63,300			66,830
Loan on Mortgage		20,000	Cash at Bank	4,500	
			„ in Hand	70	
					4,570
		£133,300			£133,300

They share profits – J four-ninths, S three-ninths, R two-ninths. The purchase consideration was £85,000 (the company taking over all the assets and liabilities except the loan on mortgage), and was payable as to £25,000 in cash, £20,000 in 5 per cent. mortgage debentures, and £40,000 in ordinary shares. Expenses amounting to £600 were payable by the firm.

Assuming the transactions to have been carried through, and the loan on mortgage repaid, close the books of the firm, the debentures and shares being divided between the partners in the following proportions: J one-half, S one-quarter, R one-quarter.

REALISATION ACCOUNT

				£
To Sundry Assets		135,300	By Provision for Bad Debts	2,000
„ Expenses		600	„ Trade Creditors	63,300
„ Capital Accounts, being profit:			„ J. S. & R. Ltd., purchase consideration	85,000
J four-ninths	£6,400			
S three-ninths	4,800			
R two-ninths	3,200			
		14,400		
		£150,300		£150,300

LOAN ON MORTGAGE

			£
To Cash	20,000	By Balance b/d.	20,000

J S & R LTD.

			£
To Realisation Account, purchase consideration	85,000	By Cash	25,000
		„ Debentures in J. S. & R. Ltd.	20,000
		„ Ordinary Shares in J. S. & R. Ltd.	40,000
	£85,000		£85,000

DEBENTURES IN J S & R LTD.

			£
To J. S. & R. Ltd.	20,000	By J Capital Account, one-half	10,000
		„ S „ „ one-quarter	5,000
		„ R „ „ one-quarter	5,000
	£20,000		£20,000

ORDINARY SHARES IN J S & R LTD.

	£		£
To J S. & R. Ltd.	40,000	By J Capital Account, one-half	20,000
		„ S „ „ one-quarter	10,000
		„ R „ „ one-quarter	10,000
	£40,000		£40,000

J CAPITAL ACCOUNT

	£		£
To Debentures in J. S. & R. Ltd.	10,000	By Balance b/d. .. .	25,000
„ Ordinary Shares in J. S. & R. Ltd.	20,000	„ Realisation Account, profit	6,400
„ Cash	1,400		
	£31,400		£31,400

S CAPITAL ACCOUNT

	£		£
To Debentures in J. S. & R. Ltd.	5,000	By Balance b/d. ..	15,000
„ Ordinary Shares in J. S & R Ltd.	10,000	„ Realisation Account, profit	4,800
„ Cash .. .	4,800		
	£19,800		£19,800

R CAPITAL ACCOUNT

	£		£
To Debentures in J. S. & R. Ltd.	5,000	By Balance b/d.	10,000
„ Ordinary Shares in J. S. & R. Ltd	10,000	„ Realisation Account, profit	3,200
		„ Cash . . .	1,800
	£15,000		£15,000

CASH ACCOUNT

	£			£
To J S. & R. Ltd.	25,000	By Loan on Mortgage . ..		20,000
„ Capital Account: R .. .	1,800	„ Expenses		600
		„ Capital Accounts:		
		J	£1,400	
		S	4,800	
				6,200
	£26,800			£26,800

Normally, where a partnership is converted into a limited company, the partners of the firm will agree as to the manner in which the shares, debentures, etc., of the company, received as purchase consideration, are to be divided between them. Where, however, the partners cannot agree upon such proportions an independent valuation of the shares, debentures, etc., should be obtained and the profit or loss disclosed thereby divided between the partners in their profit-sharing ratio. The shares, debentures, etc., at their agreed valuation, will then be divided between the partners in proportion to the adjusted balances on their capital accounts. If it is desired by the partners to share the profits of the company in the proportions in which the profits of partnership were formerly divided, the shares, debentures, etc., should be allocated to the partners in their profit-sharing ratio, a cash adjustment being made between the partners in respect of any balances remaining due to or by them individually.

§ 9. Joint Venture Accounts

'Joint venture' is defined in 'Bell's Principles', Art. 392, as follows: 'Joint adventure or joint trade is a partnership confined to a particular adventure, speculation, course of trade or voyage, and in which the partners, either latent or known, use no firm or social name, and incur no responsibility beyond the limits of the adventure.' The incidents of joint venture cannot be distinguished in any way from those of an ordinary partnership, beyond the fact that the agreement is of a specially limited character.

In actual practice joint ventures resolve themselves broadly into two classes:

(a) Where a separate set of books is opened for the transactions of the Joint Venture

In such a case, a joint banking account may be opened and the transactions recorded in a manner precisely similar to those of ordinary partnerships, each partner's Capital Account being credited with the amount which he pays into the Joint Account. Interest on capital is usually taken into consideration, and the profits or losses are divided according to the shares agreed upon.

Illustration (1)

A and B were partners in a joint venture in timber, sharing profits – two-thirds and one-third respectively. A banking account in their joint names is opened on the 1st January, A paying in £700, and B £850.

The transactions were as follows:

			£	s.	d.
Jan.	8	Purchased from F. Daponta Cargo of Timber valued at ..	665	0	0
		Accepted draft for same at one month	665	0	0
,,	11	Paid Freight and Expenses to Liverpool	142	10	0
Feb.	20	Sold T. Stephens & Sons Logs	180	0	0
,,	21	Received Cash *less* 5%	171	0	0
,,	26	Bought for Cash from Lehman & Co. Cargo of Timber, net ..	800	0	0
Mar.	17	Paid Freight and Expenses to Hull	125	0	0
		Sold M. White & Co. Deals, net	300	0	0
		Received their acceptance one month	300	0	0
April	21	Sold for Cash to M. Black & Co. Cargo purchased from Lehman & Co.	1,400	0	0
,,	30	Stock balance of Daponta's Cargo valued at	320	0	0

The venture was closed on 30th April, by B taking over the unsold stock at an agreed valuation of £320, less 10 per cent.

Adjust the accounts as between the partners at 30th April, allowing interest on capital at 5 per cent. per annum, and show:

(1) The Joint Venture Account.

(2) The Partners' Capital Accounts.

(3) The Joint Cash Account.

(4) The Joint Bills Receivable and Bills Payable Accounts.

JOINT VENTURE ACCOUNT

	£ s. d.	s. d.		£ s. d.	£ s. d.
To Purchases:			By Sales:		
F. Daponta ..	665 0 0		T. Stephens & Sons	180 0 0	
Lehman & Co...	800 0 0		M. White & Co. .	300 0 0	
		1,465 0 0	M. Black & Co. .	1,400 0 0	
„ Freight and Expenses:					1,880 0 0
Liverpool ..	142 10 0				
Hull	125 0 0		B Capital Account: value of stock taken		
		267 10 0	over, £320 *less* 10%		288 0 0
„ Discount ..	..	9 0 0			
„ Interest on Capital:					
A . ..	11 13 4				
B	14 3 4				
		25 16 8			
„ Balance, being Profit:					
A two-thirds ..	267 2 3				
B one-third ..	133 11 1				
		400 13 4			
		£2,168 0 0			£2,168 0 0

A CAPITAL ACCOUNT

			£ s. d.				£ s. d.
April	30	To Cash	978 15 7	Jan.	1	By Cash .	700 0 0
				April	30	„ Interest on Capita	11 13 4
				„		„ Profit .	267 2 3
			£978 15 7				£978 15 7

B CAPITAL ACCOUNT

			£ s. d.				£ s. d.
April	30	To Stock taken over	288 0 0	Jan.	1	By Cash . .	850 0 0
„		„ Cash ..	709 14 5	April	30	„ Interest on Capital	14 3 4
				„		„ Profit .	133 11 1
			£997 14 5				£997 14 5

CASH BOOK

			£ s. d.				£ s. d.
Jan.	1	To A Capital Account .	700 0 0	Jan.	11	By Freight and Expenses	142 10 0
		„ B „ „ ..	850 0 0	Feb.	11	„ Bills Payable	665 0 0
Feb	21	„ T. Stephens & Sons	171 0 0	„	26	„ Cash Purchases:	
April	20	„ Bills Receivable ..	300 0 0			Lehman & Co.	800 0 0
„	21	„ Cash Sales:		Mar.	17	„ Freight and Expenses	125 0 0
		M. Black & Co. ..	1,400 0 0	April	30	„ Balance c/d.	1,688 10 0
			£3,421 0 0				£3,421 0 0
April	30	To Balance b/d.	1,688 10 0	April	30	By A .	978 15 7
						„ B .	709 14 5
			£1,688 10 0				£1,688 10 0

BILLS RECEIVABLE ACCOUNT

			£ s. d.				£ s. d.
Mar.	17	To M. White & Co. ..	300 0 0	April	20	By Cash	300 0 0

BILLS PAYABLE ACCOUNT

			£ s. d.				£ s. d.
Feb.	11	To Cash	665 0 0	Jan.	8	By F. Daponta	665 0 0

In some cases, although a separate set of books is kept for the joint venture, it is not considered necessary to open a special joint banking account therefor. In these circumstances each party to the venture will disburse sums on behalf of the joint account from his own banking account, into which he will also pay cash received by him from time to time. In the books of the joint venture the Capital Accounts of the parties concerned will be credited with the sums paid out on behalf of the venture and debited with the cash collected.

Illustration (2)

A and B are partners in a joint venture in produce, sharing profits in the ratio 2 : 1. A separate set of books is opened for the venture, but all cash transactions are dealt with by the partners through their own banking accounts.

The transactions of the venture were as under:

			£
Jan.	1	Purchased produce from J. Smith	1,000
		Freight and expenses thereon paid by A	120
Feb.		J. Smith's account met by A subject to 10% cash discount	
„	13	Sold to A. Brown produce for	860
„	15	Sold to T. Jones produce for	620
March	1	Cash purchase by B for	600
April	1	Payment to B by A. Brown in settlement of his account	
May	1	Payment to A by T. Jones in settlement of his account ..	
June	1	Sundry expenses paid by A	61
		Balance of produce sold by A for £700 cash.	

The accounts of the venture are to be made up to 30th June, on which date a settlement is effected between the parties. Interest is to be calculated to the nearest £ at 5% per annum.

A CAPITAL ACCOUNT

		Mos.	Int. £	£			Mos.	Int. £	£
May 1	To Cash from T. Jones ..	2	5	620	Jan. 1	By Freight and Expenses ..	6	3	120
June 1	„ Cash Sales	1	3	700	Feb. 1	„ J. Smith	5	19	900
„ 30	„ Balance of Interest to contra		14		June 1	„ Sundry Expenses ..	1		61
					„ 30	„ Balance of Interest ..			14
			£22					£22	
	„ Cheque from B in settlement			99		„ Profit			324
				£1,419					£1,419

B CAPITAL ACCOUNT

		Mos.	Int. £	£			Mos.	Int. £	£
April 1	To Cash from A. Brown	3	11	860	Mar. 1	By Cash Purchase	4	10	600
June 30	„ Balance of Interest			1	June 30	„ Balance of Interest to contra		1	
			£11					£11	
						„ Profit			162
						„ Cheque to A in settlement			99
				£861					£861

JOINT VENTURE ACCOUNT

	£	£		£	£
To Purchases:			By Sales:		
J. Smith	1,000		A. Brown	860	
Cash	600		T. Jones	620	
		1,600	Cash	700	
„ Freight and Expenses		120			2,180
„ Sundry Expenses		61	„ Discount		100
„ Interest: A		14	„ Interest: B		1
„ Profit:					
A two-thirds	324				
B one-third	162				
		486			
		£2,281			£2,281

In their respective books A and B will keep accounts to record the payments made by them on behalf of the venture and the cash received therefrom. These accounts will appear as under:

A's BOOKS
JOINT VENTURE WITH B

		£			£
Jan. 1	To Cash – Freight and Expenses	120	May 1	By Cash – T. Jones	620
Feb. 1	„ „ J. Smith	900	June 1	„ Cash Sales	700
June 1	„ „ Sundry Expenses	61	„ 30	„ Cheque from B	99
„ 30	„ Interest Account	14			
	„ Profit and Loss Account – two-thirds of profit on venture	324			
		£1,419			£1,419

B's BOOKS
JOINT VENTURE WITH A

					£
March 1	To Cash Purchase	600	April 1	By Cash – A. Brown	860
June 30	„ Profit and Loss Account – one-third of profit on venture	162	June 30	„ Interest Account	1
	„ Cheque to A	99			
		£861			£861

(b) Where no separate set of books is opened for the transactions of the joint venture

In such a case each party will record his own transactions on behalf of the joint venture in his own books, and no joint banking account will normally be opened. In order to ascertain the profit or loss, each party must render to the other a complete statement of all transactions entered into by him, and these must then be combined into a *memorandum* Joint Venture Account. This account, which does not appear in the books of either party, but is raised from material supplied by both, is in the nature of a Profit and Loss Account. As soon as the result is ascertained, each partner will debit or credit the account for the joint venture in his own books with his share of the result, and the balance of this account, if the venture has been completed, will then represent the amount due to or by the other party.

Illustration (1)

M and R were partners in an underwriting venture, sharing profits and losses M three-fifths and R two-fifths. They agree to guarantee the subscription at par of 100,000 shares of £1 each in a company, and to pay all expenses up to allotment, in consideration of a commission of 6 per cent. in cash and 10 per cent. in fully-paid shares of the company.

M provided cash for the following expenses: Registration Fees £620; Advertising £2,700; Printing and Prospectuses £270. R provided the cash for the remainder, *viz.*, Rent of Offices £45; Petty Cash £20; Stamps £90; Law Costs £250. The whole of the commission was received by M.

The public having subscribed only 70,000 shares, the underwriters had to take up 30,000, the cash being provided by and shares allotted to them in the proportions of – M three-fifths and R two-fifths.

In due course they sold all the shares except 5,000, including those received for commission, at an average price of 15s. 3d., less brokerage of 3d. per share, the remaining 5,000 being taken over by M at 12s 6d. per share. The sales were effected as to 21,000 by M and 14,000 by R.

Prepare a Joint Venture Account, and the separate accounts of the partners in their own books, showing the final balance payable by the one to the other, the shares taken over by M being brought into account, and no interest being taken into consideration.

M's BOOKS
JOINT ACCOUNT WITH R

	Shares £	£		Shares £	£
To Cash – Expenses .		3,590	By Cash – Commission .		6,000
„ „ Shares taken up ..	18,000	18,000	„ „ Proceeds of Shares sold	21,000	15,750
„ Shares received as Commission	10,000		„ Own Investment Account – Shares taken over ..	5,000	3,125
„ Profit and Loss Account: three-fifths of £1,380		828	„ Shares sold by R .	2,000	
„ Balance due to R .. .		2,457			
	£28,000	£24,875		£28,000	£24,875
			By Balance due to R ..		2,457

R's BOOKS
JOINT ACCOUNT WITH M

	Shares £	£		Shares £	£
To Cash – Expenses .		405	By Cash – Proceeds of Shares sold	14,000	10,500
„ „ Shares taken up .	12,000	12,000	„ Balance due from M .		2,457
„ Shares drawn from M ..	2,000	—			
„ Profit and Loss Account: Two-fifths of £1,380		552			
	£14,000	£12,957		£14,000	£12,957
To Balance due from M ..		2,457			

MEMORANDUM JOINT VENTURE ACCOUNT

		£			£
To Expenses paid by M:			By Cash – Underwriting Commission		6,000
Registration Fees .	620		„ Sale of 35,000 shares at 15s. net:		
Advertising ..	2,700		M	15,750	
Printing, etc. ..	270		R	10,500	
		3,590			26,250
„ Expenses paid by R:			Shares taken over by M, 5,000 @ 12s. 6d.		3,125
Rent	45				
Petty Cash ..	20				
Stamps	90				
Law Costs ..	250				
		405			
„ Cost of Shares taken up:					
M	18,000				
R	12,000				
		30,000			
„ Balance, being Profit:					
M three-fifths ..	828				
R two-fifths ..	552				
		1,380			
		£35,375			£35,375

Notes to Illustration

(1) It is preferable to place no value on the shares received as commission until they are sold, when the proceeds are credited to the Joint Account. As these shares were received by M the receipt and sale thereof appear in the Joint Account in his books.

(2) The shares allotted to M and R respectively are the property of the partnership, not of the individual partners; they represent the stock-in-trade of the venture, part of which is in the custody of M and part of R. Where it is necessary for one partner to draw on stock held by the other for the purpose of effecting delivery of shares sold, this involves no payment of cash between the partners, but each partner must account to the venture for the proceeds of the sales effected by him. Thus, R must credit his Joint Account with the proceeds of the 14,000 shares sold by him, although delivery of 2,000 of these shares must be made out of the shares held by M.

(3) The 5,000 shares taken over by M represent a purchase by him from the venture, the agreed price being credited to the Joint Account in his books as the proceeds of a sale by venture, and debited to M's Personal Investment Account.

An alternative method is for one (or each) of the partners to record the *whole* of the transactions in his own books, in which, in addition to the Joint Venture Account, a personal account for the other partner will be opened. The Joint Venture Account will be debited with all the payments made, and credited with all the sums received, by *both* partners, the cash book being credited with the payments made and debited with the receipts of the partner in whose books the transactions are being recorded, and the personal account of the other partner credited and debited respectively with the payments and receipts made by him. Any stock taken over by the partners will be credited to the Joint Venture Account, and debited, in the case of the first named partner, to his purchases or other appropriate account, and in the case of the other partner, to his personal account.

The profit disclosed by the Joint Venture Account will be divided between the partners according to the agreement between them, the first-named partner's share being credited to his own Profit and Loss Account or Capital Account, and the other partner's share to his personal account. A loss will be treated in the converse manner. The balance remaining on the personal account of the other partner will now represent the sum due to or from him to close the venture.

Illustration (2)

Bear and Bull agreed to deal in stocks and shares on joint account and to share any profits or losses equally.

The following transactions took place:

(1) 4th January. Bear purchased 2,000 £1 shares in Washers Ltd. at 35s. per share, expenses amounting to £34.

(2) 10th January. Bull purchased 1,000 £1 Ordinary Stock units in Assurances Ltd. at 42s. cum div., expenses amounting to £32.

(3) 30th March. Bull purchased a further 500 £1 Ordinary Stock units in Assurances Ltd. at 40s. ex div., expenses amounting to £16.

B's BOOKS
JOINT ACCOUNT WITH A (*continued*)

		£			£
June 30	To Balance b/d.	490	June 30	By Agent Sales	2,000
	" Agent's Commission	100			
	" Profit	270			
	" Cash to A in settlement	1,140			
		£2,000			£2,000

MEMORANDUM JOINT VENTURE ACCOUNT

		£	£			£
Jan 1	To Goods supplied, A	3,000		Mar.31	By Sales	5,500
	" " " B	1,000			" Balance c/d.—stock unsold	
			4,000			
	" Expenses A	400				
	" " B	500				
			900			
Mar.31	" Agent's Commission		275			
	" Profit: A three-fifths	930				
	B two-fifths	620				
			1,550			
			£6,725			
Apr. 1	To Balance Stock b/d		1,225	June 30	By Sales	2,000
	" Agent's Commission		100			
	" Profit—A three-fifths	405				
	B two-fifths	270				
			675			
			£2,000			£2,000

Note. The unsold stock at 31st March is valued as follows:

One-fourth of £4,000, cost of goods	..	£1,000
One-fourth of £900, expenses	..	225

£1,225 – apportional A $\frac{3}{5}$ths .. £735
B $\frac{2}{5}$ths .. 490

£1,225

At the conclusion of the venture, A has received from B a total of £4,735, being the amount of his expenditure on the venture, £3,400, plus his share of the profit, £1,335. B has received back his expenditure of £1,500 plus his share of the profit £890 — £2,390, represented by:

Remittances received from Agent	.. ..	£7,125
Less paid to A	.. ..	4,735
		£2,390

COMPANY ACCOUNTS

N.B.—Section references in this chapter are to the Companies Act, 1948, except where otherwise indicated.

§1. The Distinction between Partnerships and Limited Liability Companies

The law relating to companies has evolved slowly, having been amended from time to time to keep pace with the developments of commerce. It is now embodied in the Companies Act, 1948, under which the large majority of companies are governed.

Companies may be registered with limited or unlimited liability, but it is considered necessary to deal here only with the former class, in which the liability of the members for the company's debts is limited to the amount which, on becoming members, they undertake to contribute to the company's capital.

Companies with limited liability may be limited either by guarantee or by shares. In the former class, each member undertakes to contribute a specified sum towards the liabilities of the company in the event of its being wound up. In the case of a company limited by shares, the capital is divided into a number of shares, and the liability of each member is limited to the amount for the time being unpaid on the shares which he has agreed to take up.

The principal distinctions between an unlimited partnership and a limited company are as follows:

1. A partnership has no legal identity apart from its members. A company has a SEPARATE LEGAL ENTITY, which is not affected by changes in its membership. It may contract, sue and be sued in its corporate name and capacity.

2. In the case of an unlimited partnership, the LIABILITY of each member of the firm for the debts of the firm is unlimited; in the case of a limited company, the liability of each shareholder is limited to the amount he has agreed to pay to the company for the shares allotted to him, and if such shares are fully paid up he is subject to no further liability.

3. In the case of a partnership, the NUMBER OF PARTNERS IS LIMITED to twenty, except in the case of a private banking concern, where the number is limited to ten. In the case of a public company, the number of shareholders is only limited by the number of shares authorised and issued, but there cannot be less than seven members. In a private company, the number of members must not exceed fifty, exclusive of past and present employees, and cannot be less than two.

4. If, in a partnership, the LEGAL NUMBER of partners is exceeded, the association is an illegal one, and, although this does not affect the question of the partners' liability, seeing that this was unlimited in the first instance, they cannot take legal action for the enforcement of contracts or rights, although they are capable of being sued. In the case of a public company, if the number of members sinks below seven, or in the case of a private company, below two, this is good ground for the presentation of a petition for winding-up; but as regards the liability of the members, six months' grace is given, and after this time has expired all those members cognisant of

the fact that the number has sunk below seven, or two, as the case may be, are severally liable for the whole of the debts of the company contracted after the expiration of the six months.

5. In the case of an unlimited partnership, each member can normally take part in the MANAGEMENT of the business, and can legally bind the firm by his actions with the outside world within the scope of his real or apparent authority; whereas in the case of a company, the rights of management are delegated to persons called directors, who alone can act on behalf of, and bind, the company.

6. In the case of a partnership, each member is entitled to have ACCESS TO THE BOOKS and accounts of the firm; whereas in the case of a company, the right of the members to inspect the books, with the exception of the books open for inspection by statute, depends on the articles.

7. In the case of a partnership, the RIGHTS OF THE PARTNERS as between themselves are governed by agreement, which itself can be varied by agreement between the partners. In the case of a company, the powers, which can only be altered in the manner and within the limits laid down by the Companies Act, are defined by the memorandum of association; and the powers and duties of the directors carrying on the business are defined by the articles of association, which can only be altered by special resolution of the company in general meeting.

8. A partnership is subject to the general provisions of the Partnership Act, 1890, which, however, can be varied to some extent in so far as affects the relationship of the partners *inter se* by mutual agreement (and in appropriate cases to the provisions of the Limited Partnerships Act, 1907, and the Registration of Business Names Act, 1916); a company is subject to the Companies Act, the provisions of which cannot legally be varied by the company.

9. The CAPITAL of a partnership is contributed by the partners according to agreement, and is not necessarily fixed in amount, being frequently increased by undrawn profits, or reduced by losses sustained, or by withdrawals; whereas in the case of a company, the authorised capital is fixed by the memorandum, and cannot be reduced without a special resolution and leave of the Court; or increased, except by resolution of the company in general meeting.

10. The share of a partner in a firm cannot be transferred, except by agreement between all the partners; in the case of a company, shares are freely transferable, subject only to any restrictions imposed by the Articles.

11. A limited company is required by statute to keep prescribed BOOKS OF ACCOUNT, under serious penalties for default; there is no such statutory obligation on a partnership.

12. In the case of a private firm, an annual AUDIT is not compulsory, whereas in the case of a company it is.

13. The PROFITS of a partnership may be withdrawn by the partners as and when ascertained, or periodical drawings on account of profits may be made by mutual agreement. In the case of a company, the profits are distributed by means of dividends calculated at a percentage or at a rate per share. Such distribution is only made on the

authority of a resolution passed by the company in general meeting, although the articles may provide for interim dividends to be declared by the directors.

A limited company, as compared with a partnership, offers the following additional advantages:

1. The share of a deceased member is more readily ascertainable and transferable. Moreover, the actual carrying on of the business is not liable to be so disturbed by the death of a member as it is in the case of a partnership. Whereas, subject to any agreement to the contrary, the death of a partner dissolves the firm, the death of a member does not affect the legal existence of a company.

2. The control of a company can be secured by one or more members holding the shares (or a majority of them) which carry the voting rights. Additional capital can be obtained by the issue of further shares, *e.g.*, preference shares, without the disturbance of such controlling interest.

3. Family provision is facilitated; *e.g.*, a parent can transfer shares to children, whilst retaining control, whereas if he took them into partnership, they would have all the rights and liabilities of partners.

4. A larger capitalisation of the business is possible, since it is much easier, as a rule, to raise large or small units of capital where the holders will have the protection of limited liability than where they would be partners.

5. An interest in the business can be given to employees in the form of shares, without loss of control.

6. By transferring a business to a company the proprietor is able to realise the goodwill, either for a cash consideration or for shares, without relinquishing control of the business. A material saving in surtax may be effected on the profits retained in the business, since, provided a reasonable proportion of the profits is distributed, only the distributed profits are liable to surtax in the hands of the company's members, whereas the whole profits of a partnership, whether drawn out of the business or not, are chargeable to surtax on the partners. This advantage may, however, be neutralised by the fact that the company is liable to profits tax, whereas a partnership is not.

On the other hand, limited companies are more subject to statutory and constitutional restrictions, and a certain amount of publicity is given to their affairs; heavy stamp duties and fees are payable upon incorporation; companies are liable to profits tax and dividends from companies are regarded as unearned income for taxation purposes. The last disadvantage can, however, be overcome to the extent that the profits are paid to the members as directors' fees. In some isolated cases, also, the credit of the company may not be so favourably regarded by trade creditors as was that of the former partnership.

§ 2. Private Companies

A PRIVATE COMPANY is defined by Section 28, as a company which *by its articles:*

(*a*) restricts the right to transfer its shares; and

(*b*) limits the number of its members to 50 (joint holders being treated as one person), not including persons who are in the employment of the company, and persons

who, having been formerly in the employment of the company were, while in such employment, and have continued after the determination of such employment, to be members of the company; and

(*c*) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

Every company which does not contain such clauses in its articles is a PUBLIC COMPANY.

If default is made by a company in complying with any of the provisions of its articles which constitute it a private company, the company will cease to be entitled to the privileges and exemptions conferred on private companies, but the Court may give relief if the default is accidental or on other reasonable cause (§ 29).

If a private company alters its articles so that they no longer include the above provisions, the company forthwith ceases to be a private company, and must, within fourteen days, deliver to the registrar of companies a prospectus, or a statement in lieu of prospectus, in the prescribed form (§ 30).

One of the privileges which was accorded to every private company prior to 1st July, 1948, was exemption from the obligation to annex to its annual return (which must be filed with the registrar of companies) a certified copy of its balance sheet, including every document required by law to be annexed thereto. As from 1st July, 1948, however, this exemption only applies to a private company which has at all times since 1st July, 1948 (or the date of its first registration, if later) satisfied the undermentioned conditions, and sends, with its annual return, a certificate signed by a director and the secretary that to the best of their knowledge and belief, the said conditions are and have been, so satisfied. The Board of Trade has power, on application by the directors, to exempt a company which has not previously satisfied the conditions, but is satisfying them at the date of the annual return (§ 129).

A company which satisfies these conditions is referred to as an EXEMPT PRIVATE COMPANY.

The conditions are:

(*a*) that no body corporate is the holder of any of its shares or debentures;

(*b*) that no person other than the holder has any interest in any of the shares or debentures;

(*c*) that the number of persons holding debentures of the company is not more than fifty (joint holders being treated as a single person);

(*d*) that no body corporate is a director of the company, and neither the company nor any of the directors is party or privy to any arrangement whereby the policy of the company is capable of being determined by persons other than the directors, members and debenture holders.

In the following circumstances, however, the fact that a person other than the holder has an interest in the shares or debentures, or that a body corporate holds shares or debentures in the company, as the case may be, will not affect the exemption of the company:

1. Where any share or debenture is subject to a charge in favour of a banking or finance company by way of security, for the purposes of a transaction entered into in the ordinary course of business, the interest of that banking or finance company is disregarded:

2. If the banking or finance company or its nominee is the holder of any share or debenture as security, then the person entitled to the equity of redemption in that share or debenture shall be treated as the holder;

3. Any interest under a contract for the transfer of any shares or debentures shall be disregarded until execution of an instrument of transfer, unless the execution thereof is unreasonably delayed. On execution of the transfer the transferee will be the holder of the shares unless the company refuses to register the transfer;

4. Any interest of the company itself in any of its shares or debentures and any lien or charge thereon arising by operation of law shall be disregarded;

5. Where shares or debentures form part of the estate of a deceased person, so long as the administration of his estate is not completed;

6. Where shares or debentures are held by a trustee on the trusts of a will or family settlement disposing of those shares or debentures, so long as no body corporate has any immediate interest therein under the trust;

7. Where shares or debentures are vested in a trustee or administrator or other person for a person of unsound mind;

8. Where shares or debentures are held by a trustee for the purpose of a scheme maintained for the benefit of employees of the company, including any director holding a salaried employment or office in the company;

9. Where shares or debentures are held by a banking or finance company or its nominee acquired in the ordinary course of business; but this exception will not apply if one-fifth or more of the shares carrying voting power are held in this way;

10. Where any shares or debentures form part of the assets in a bankruptcy or liquidation of a holder thereof or are held on trusts created for his creditors or are held for the purpose of a composition or scheme made or approved by the Court;

11. The condition that no body corporate is the holder of any shares of or debentures in the company is subject to an exception for shares in the company held by another body corporate which is itself an exempt private company. For this exception to apply, however, the company itself (the 'relevant company'), the company holding shares therein, and any further company which has to be taken into account in determining the right to be treated as an exempt private company of the company holding shares in the relevant company, must together have a total membership of not more than fifty persons, joint shareholders being treated as a single person, and the companies themselves and their employees and former employees being disregarded.

In addition to the exemption from the obligation of filing a copy of its balance sheet with its annual return, an *exempt* private company is entitled to the following special privileges:

1. Its auditor need not possess a professional qualification or be authorised by the Board of Trade (§ 161).

2. A partner or employee of an officer or servant of the company is not disqualified from appointment as auditor (§ 161).

3. Copies of certain resolutions and agreements which must be filed with the registrar of companies, need not be printed (§ 143).

4. Loans may be made by the company to its directors (§ 190).

Apart from the above, which are applicable only in the case of companies which satisfy the conditions necessary to constitute them exempt private companies, the following privileges are enjoyed by *every* private company, whether an exempt private company or not:

1. It may have a minimum of two members (§ 1).
2. It need not issue a prospectus or statement in lieu of prospectus (§ 48).
3. It can commence business immediately on incorporation (§ 109).
4. The minimum number of directors is one instead of two (§ 176).
5. There are no restrictions on the appointment of directors by the Articles (§ 181).
6. The age limit of 70 in respect of directors does not apply (§ 185).
7. A separate resolution is not required for the appointment of each director individually (§ 183).
8. Neither a statutory meeting nor a statutory report is required (§ 130).

A certificate signed by a director and the secretary must be given on the annual return of a private company to the effect that no invitation has been issued to the public to subscribe for any shares or debentures, and where it appears from the list of members that the number of members exceeds fifty, a further certificate must be given stating that the excess comprises employees or ex-employees who were members when employed by the company and have continued to be members since ceasing to be so employed (§ 128).

As already stated, if the company is an exempt private company, an additional certificate must be given that the conditions constituting the company an exempt private company are satisfied (§ 129).

§ 3. The Memorandum and Articles of Association

(*a*) The **Memorandum of Association** is the document forming the constitution of a company, and defining its objects and powers.

The memorandum of association of a company limited by shares contains five clauses:

1. The name of the company, which must end with the word 'limited'.
2. The domicil of the company, *i.e.*, whether its registered office is to be situated in England (which includes Wales) or Scotland.
3. The objects of the company.
4. A declaration that the liability of the members is limited.
5. The amount of capital, and the shares into which it is divided.

The memorandum must be signed by not less than seven persons, or not less than two in the case of a private company, agreeing to take up not less than one share each.

(*b*) The **Articles of Association** contain the rules and regulations for conducting the business of the company, and define the rights of the members and the powers and duties of the directors. The principal clauses are as follows:

1. A declaration as to how far the provisions of Table A are expressly excluded. In so far as the articles do not exclude or modify the regulations in Table A, the latter are applicable.

Table A is a model set of articles which automatically applies to any company limited by shares not having articles of its own. The present Table A contained in the Companies Act, 1948 applies to any company registered after 30th June, 1948. Any company working under an earlier Table A can adopt the present Table A by special resolution.

The present form of the revised table, which came into force on the 1st July, 1948, forms a schedule to the Companies Act, 1948.

Many companies register special articles excluding Table A entirely, in which case most of the clauses of Table A, modified where expedient, are in fact reproduced in the special articles.

2. A recital of the basis on which the company is constituted.
3. The regulations as to the issue of capital and variation of rights of members, lien on shares, payment of underwriting commission, etc.
4. The making of calls on shares.
5. The transfer and transmission of shares.
6. The forfeiture and surrender of shares; conversion of shares into stock, and alteration of capital.
7. The holding, notice of, and procedure at general meetings.
8. The votes of members; polls and proxies.
9. The directors—their number, remuneration, qualification, rotation, disqualification and removal.
10. The appointment and powers of managing directors.
11. The proceedings and powers and duties of the board of directors.
12. The borrowing powers of the company.
13. The appointment, remuneration, removal, etc., of the secretary.
14. The use of the company's seal.
15. Accounts and audit.
16. Dividends and reserves.
17. The capitalisation of profits.
18. Notices to members.
19. The rights of members *inter se*.

§ 4. The Statutory Books and Returns

(a) The Register of Members

Under Section 110 every company must keep a register of its members, and enter therein the following particulars:

(i) The names and addresses of the members, and in the case of a company having a share capital, a statement of the shares held by each member, distinguishing

each share by its number so long as the share has a number, and of the amount paid or agreed to be considered as paid on the shares of each member.

(ii) The date at which each person was entered in the register as a member.

(iii) The date at which any person ceased to be a member.

Where the company has converted any of its shares into stock and given notice of the conversion to the registrar of companies, the register must show the amount of stock held by each member instead of the amount of shares and the particulars relating to shares specified above.

The register of members must be kept at the registered office of the company, unless the work of making it up is done at another office of the company or of the person making it up when it can be kept there, provided that other office is not outside the country of the company's domicil. If the register is not kept at the registered office at all times after 1st July, 1948, the company must file with the registrar of companies the address where it is kept and any change in that address (§ 110).

When the company has more than fifty members, and the register is not in such a form as to constitute, in itself, an index, an index must be kept at the same place as the register for the purpose of facilitating ready reference. Any alteration in the register must be reflected in the index (where necessary) within fourteen days. A loose leaf register kept in alphabetical order therefore appears desirable.

The register and index must be open to the inspection of members of the company without charge, and of other persons at a fee not exceeding one shilling, for at least two hours on each business day. Copies of any part of the register can be required by any person on payment (§ 113). The company has power on giving notice by newspaper advertisement (§ 115) to close the register for an aggregate of thirty days in each year, thus permitting and facilitating the preparation of the annual return and the dividend warrants to shareholders.

The register of members is generally combined with the share ledger, until the shares are fully paid (*see* § 8 (*a*) *post*). Once the shares are fully paid, however, the share ledger can be closed, and where transfers are numerous, the details thereof will not be included in the share register.

(b) The Register of Charges

Under Section 104 every limited company must keep at its registered office a register of charges, and enter therein all charges specifically affecting property of the company, and all floating charges on the undertaking or any property of the company, giving in each case a short description of the property charged, the amount of the charge, and, except in the case of securities to bearer, the names of the persons entitled thereto.

This book and a copy of every instrument creating any charge must be open for inspection by any creditor or member of the company without charge, and by any other person on payment of a fee not exceeding one shilling, for at least two hours on each business day (§ 105).

The following is the usual form of this book :

Illustration

REGISTER OF CHARGES

Date of Charge.	Name and Address of Mortgagee.	Short Particulars of Property Charged.	Amount of Charge.	Remarks.

(c) Register of Debenture Holders

Although a company is under no statutory obligation to keep a separate register of debenture holders, if such a register is kept at an address other than its registered office, notice of the address at which it is kept must be given to the registrar of companies, as in the case of the share register. Notice must also be given of the situation of duplicate registers in England (by a Scottish company) or Scotland (by an English company) unless such register has always been kept at the same place (§ 86). Registers of debenture holders must be open to inspection in the same way as registers of members (§ 87).

(d) Annual Return

Every company having a share capital must once at least in every year make a return containing the names and addresses of all persons who, on the fourteenth day after the company's annual general meeting for the year, are members of the company, and of persons who have ceased to be members since the date of the last return, or, in the case of the first return, of the incorporation of the company (§ 124).

The list must state the number of shares held by each of the existing members at the date of the return, specifying shares transferred since the date of the last return (or in the case of the first return, since the incorporation of the company), by persons who are still members and by persons who have ceased to be members respectively, and the dates of registration of the transfers; and if the names therein are not arranged in alphabetical order, must have annexed to it an index sufficient to enable the name of any person in the list to be readily found.

Where, however, the company has converted any of its shares into stock and given notice of the conversion to the registrar of companies, the list must state the amount

of stock held by each of the existing members instead of the amount of shares and the particulars relating to shares.

In any year, if the return for either of the two immediately preceding years has given the full particulars mentioned above, there need only be included in the return particulars of persons ceasing to be or becoming members since the date of the last return, and to shares transferred or changes in stock held since that date, *i.e.*, a full return of members who do not change their holdings need only be made every third year.

The return must also state the address of the registered office of the company and if the register of members or of debenture holders is not kept there, the address at which it is kept, and must contain a summary distinguishing between shares issued for cash and shares issued as fully or partly paid up otherwise than in cash, and specifying the following particulars:

(*a*) The amount of the share capital of the company, and the number of the shares into which it is divided.

(*b*) The number of shares taken from the commencement of the company up to the date of the return.

(*c*) The amount called up on each share.

(*d*) The total amount of calls received.

(*e*) The total amount of calls unpaid.

(*f*) The total amount of the sums, if any, paid by way of commission in respect of any shares or debentures.

(*g*) The discount allowed on the issue of any shares issued at a discount, or of so much of that discount as has not been written off at the date on which the return is made.

(*h*) The total amount of the sums, if any, allowed by way of discount in respect of any debentures, since the date of the last return.

(*i*) The total number of shares forfeited.

(*j*) The total amount of shares for which share warrants are outstanding at the date of the return, and of share warrants issued and surrendered respectively since the date of the last return, and the number of shares comprised in each share warrant.

(*k*) The total amount of the indebtedness of the company in respect of all mortgages and charges which are required (or, in the case of a company registered in Scotland, which, if the company had been registered in England, would be required) to be registered with the registrar of companies under the Act, or which would have been required so to be registered if created after 1st July, 1908.

(*l*) All such particulars with respect to the persons who at the date of the return are the directors of the company, and any person who at that date is the secretary of the company as are by the Act required to be contained with respect to directors and the secretary in the register of directors and secretaries of a company.

The return must be in accordance with the form set out in the Sixth Schedule to the Act, or as near thereto as circumstances admit.

In the case of a company keeping a dominion register, the particulars of the entries in that register must, so far as they relate to matters which are required to be stated in the return, be included in the return made next after copies of those entries are received at the registered office of the company, but the full particulars (including existing members) must be included.

A company need not make an annual return in the year of its incorporation, and if no annual general meeting is held in the following year (because the first general meeting, which must be held within eighteen months of incorporation, does not fall in that year (§ 131)), it need not file an annual return in that year either.

The copy to be filed with the registrar must be signed by a director and the secretary and delivered within forty-two days after the annual general meeting for the year. Should no meeting be held in any calendar year, the registrar will require the return to be made up to the 31st December.

Except in the case of exempt private companies, and of assurance companies which have complied with the provisions of Section 8 of the Assurance Companies Act, 1958 (*i.e.* which have submitted a copy of their accounts to the registrar when depositing copies with the Board of Trade), a copy (certified by a director and the secretary to be a true copy) of every BALANCE SHEET laid before the company in general meeting during the period to which the return relates, together with a copy of the AUDITOR'S REPORT, and including every document (*e.g.*, director's report, profit and loss account and group accounts in the case of a holding company) required by law to be annexed to the balance sheet, must be annexed to the annual return. If the balance sheet does not comply with statutory requirements as to its form, etc., it must be amended accordingly (§ 127). The Act states that a 'written' copy of such balance sheet must be filed, but the registrar will accept a printed or type-written copy if properly certified by a director, or the manager or secretary of the company.

(As to the certificates required from a private company, see the last two paragraphs of § 2 *ante*.)

(c) Minute Books

Every company must cause minutes of all proceedings of general meetings, all proceedings at meetings of its directors and, where there are managers, all proceedings at meetings of its managers, to be entered in books kept for that purpose.

Any such minute, if purporting to be signed by the chairman of the meeting at which the proceedings were had, or by the chairman of the next succeeding meeting, is evidence of the proceedings.

Where minutes have been so kept, then, until the contrary is proved, the meeting is deemed to have been duly held and convened, and all proceedings had thereat to have been duly held, and all appointments of directors, managers or liquidators are deemed to be valid (§ 145).

The minute books containing records of the proceedings at general meetings of the company must be kept at the registered office and for at least two hours on each business day be open to the inspection of any member without charge (copies can be obtained on payment (§ 146)).

There is no provision as to inspection by members of the minutes of meetings of directors, nor would such inspection normally be desirable.

Any register, index, minute book or book of account may be kept either by making entries in bound books or by recording the matters in question in any other manner. If they are not kept in a bound book, adequate precautions must be taken for guarding against falsification and for facilitating its discovery (§ 436).

(f) Register of Directors and Secretaries

Every company must keep at its registered office a register of its directors and secretaries containing with respect to each of them the following particulars:

(*a*) in the case of an individual director, his present christian name and surname, any former christian name and surname, his usual residential address, his nationality, his business occupation, if any, particulars of any other directorships held by him, and, in the case of a company that is not a private company (or if a private company, is a subsidiary of a company incorporated in the United Kingdom which is neither a private company, nor registered in Northern Ireland with provisions which, if it were registered in Great Britain would make it a private company), the date of his birth; and

(*b*) in the case of a corporation, its corporate name and registered or principal office.

It is not necessary, however, for the register to contain particulars of directorships held in companies of which the company is a wholly-owned subsidiary, or which are the wholly-owned subsidiaries either of the company or of another company of which it is a wholly-owned subsidiary. For this purpose the expression 'company' includes any body corporate incorporated in Great Britain, and a body corporate is a wholly-owned subsidiary of another if it has no members except that other and its wholly-owned subsidiaries or nominee(s) (§ 200).

As regards the secretary or secretaries, the register must contain:

(*a*) in the case of an individual, his present christian name and surname, any former christian name and surname and his usual residential address, and

(*b*) in the case of a corporation or Scottish firm, its corporate or firm name and registered or principal office.

If all partners in a firm are joint secretaries, the name and principal office of the firm may be stated instead of particulars of each.

The company must, within a period of fourteen days from the appointment of the first directors of the company, send to the registrar of companies a return in the prescribed form containing the particulars specified in the said register, and within fourteen days from the happening thereof a notification in the prescribed form of any change among its directors or secretary or in any of the particulars contained in the register (§ 200).

The register is to be open to the inspection of any member of the company without charge, and of any other person at a charge not exceeding one shilling, for at least two hours on each business day.

(g) Register of Directors' Shareholdings

Every company must keep a register showing as respects each director (not being its holding company), the number, description and amount of any shares in or debentures of the company (or any holding or subsidiary company or subsidiary company of the company's holding company) which are held by or in trust for him or of which he has any right to become the holder (whether on payment or not). The register need not include shares in a wholly-owned subsidiary (*i.e.*, a company in which all the members are the holding company and its wholly-owned subsidiaries and its or their nominees). When any shares or debentures fall to be or cease to be recorded in the register by reason of a transaction entered into after 30th June, 1948, while the owner was a director, the register must shew the date of, and price or other consideration for the transaction (§ 195 .

A director may require the nature and extent of his interest or rights in or over the shares or debentures to be recorded.

The register must be kept at the registered office, and must be open to inspection by any member or debenture holder for at least two hours in every business day, during the period beginning fourteen days before the annual general meeting and ending three days after its conclusion, and at any time for inspection by a representative of the Board of Trade. The register must be open and accessible throughout the annual general meeting to any person attending the meeting.

A person in accordance with whose directions or instructions the directors are accustomed to act is deemed to be a director for the above purposes; and a director of a company is deemed to hold, or to have an interest or right in or over, any shares or debentures if a body corporate other than a company holds them or has that interest or right in or over them, and either,

(i) that body corporate or its directors are accustomed to act on his directions or instructions, or

(ii) he is entitled to exercise or control the exercise of one-third or more of the voting power at any general meeting of that body corporate.

It is the duty of every director to give notice to the company of such matters relating to himself as are necessary for the above purposes (§ 198).

(h) The Directors' Report for the Statutory Meeting

The STATUTORY MEETING of a PUBLIC COMPANY is a general meeting of the members which must be held not less than one month nor more than three months after the company is entitled to commence business. A STATUTORY REPORT must be prepared, to be laid before the meeting, and this must, at least fourteen days before the date fixed for the holding of the meeting, be forwarded to every member of the company. If the statutory report is forwarded later than fourteen days before the

meeting, it is nevertheless valid if all the members entitled to attend and vote at the meeting so agree. A copy must be filed with the registrar of companies forthwith, after being so forwarded. The provisions relating to the statutory meeting and the statutory report DO NOT APPLY TO PRIVATE COMPANIES.

The report, which must be certified by not less than two directors, must show:

(*a*) the total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are so paid up, and in either case the consideration for which they have been allotted;

(*b*) the total amount of cash received by the company in respect of all the shares allotted, distinguished as aforesaid;

(*c*) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company;

(*d*) the names, addresses and descriptions of the directors, auditors (if any), managers (if any), and secretary of the company; and

(*e*) the particulars of any contract, the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification, or proposed modification.

The statutory report, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on capital account, must be certified as correct by the auditors (if any) of the company (§ 130).

Illustration

The Explorations Trust, Limited (directors, H. Martin, J. Williams, and J. Smithson; secretary, T. Mason; auditors, Gilbertson & Co.), was entitled to commence business on 1st April, 1958.

80,000 shares of 10s. each had been applied for and duly allotted, and 2s. 6d. per share payable on application, with 2s. 6d. per share payable on allotment, had been received by the company. An additional 10,000 shares were, under the purchase agreement, allotted to the vendors as fully paid.

Prior to the date of the report, trading receipts and payments amounted to £4,932 and £6,195 respectively, and the following payments had also been made:

	£	s.	d.
On account of Preliminary Expenses	2,500	0	0
Investments	10,000	0	0

The balance of cash is with The London and Northern Bank, on Deposit and Current Account.

The preliminary expenses are estimated in the prospectus at £3,500.

Prepare the statutory report necessary under Section 130 of the Companies Act, 1948.

THE COMPANIES ACT, 1948.

REPORT

(Pursuant to Section 130 of The Companies Act, 1948)

of

THE EXPLORATIONS TRUST, LIMITED.

(*a*) The total number of shares allotted is 90,000 of 10s. each, of which 10,000 are allotted as fully paid up in consideration of part of the purchase price of sundry assets acquired by the company, and upon each of the remaining shares the sum of 5s. has been paid in cash.

(*b*) The total amount of cash received by the company in respect of the shares issued wholly for cash is £20,000.

(*c*) The receipts and payments of the company to 20th June, 1958, are as follows.

Particulars of Receipts.		Particulars of Payments.	£
To Amount received on Application and Allotment of 80,000 Shares . . .	20,000	By Preliminary Expenses .. .	2,500
,, Trading receipts .	4,932	,, Investments	10,000
		,, Trading Payments .	6,195
		,, Balance on Deposit and Current Accounts with the London and Northern Bank	6,237
	£24,932		£24,932

The following is an Account (or Estimate) of the Preliminary Expenses of the Company :—

	£
Estimated at	3,500

(*d*) Names, Addresses and Descriptions of the Directors, Auditors (if any), Managers (if any), and Secretary of the Company.

DIRECTORS.

Surname	Christian Name.	Address.	Description.
Martin	Henry ...	The Towers, Blankton.	Director of Exzed, Ltd.
Williams	John .	16, West Side, Seaside	Solicitor.
Smithson	James	Holm, Essex.	Chartered Accountant.

AUDITORS.

	Christian Name.	Address.	Description.
Gilbertson & Co.		1641, Coleman Street, London, E.C.2.	Chartered Accountants.

MANAGERS.

Surname.	Christian Name.	Address.	Description.

SECRETARY.

Surname.	Christian Name.	Address.	Description.
Mason	Thomas	Braeside, Oxbridge.	Company Secretary.

(*e*) Particulars of any Contract the modification of which is to be submitted to the Meeting for its approval, together with the particulars of the modification or proposed modification:

We hereby certify this Report,

H. MARTIN. } *Director*
J. WILLIAMS. }

We hereby certify that so much of this Report as relates to the shares allotted by the Company and to the Cash received in respect of such shares and to the receipts and payments of the Company on Capital Account is correct.

GILBERTSON & CO., *Auditors*

Dated the 21st day of June, 1958.

(i) The Books of Account

The provisions of the Act as to accounting are dealt with *post* in § 15.

§ 5. The Various Classes of Share Capital

A share has been defined as 'the interest of a shareholder in the company measured by a sum of money for the purpose of liability in the first place, and, of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders, *inter se*'.

The share capital of a company may be divided into different classes of shares, of which the following are the most usual:

(a) Preference Shares

Preference shares entitle the holders to a fixed rate of dividend before any dividend is paid on other classes of shares. They may also carry the right, by virtue of the articles, to repayment of capital, on a winding-up, in priority to other types of shares.

Preference shares may be either *cumulative* or *non-cumulative*. The latter only carry a right to a fixed dividend out of the profits of any year, and if there are insufficient profits in that year to pay the full amount of dividend they have no right to have the arrears made up out of future profits. They may or may not have a right, in the event of liquidation, to repayment of capital in priority to other classes of shares.

Cumulative preference shares entitle the holders to a fixed rate of dividend in the same way as non-cumulative preference shares, but with the additional right to have any arrears of dividend paid out of future profits before any dividends are paid on other classes of shares.

The rights of preference shareholders are entirely governed by the memorandum and articles of association, and there are other varieties than those enumerated above; for example, a company may have PARTICIPATING PREFERENCE SHARES, which carry a right, in addition to a fixed dividend, to further participation in profits after a dividend of a specified rate has been paid on the ordinary shares. In the absence of express or implied provision in the articles to the contrary, preference shares are *cumulative* as to dividend, but are only entitled to rank *pari passu* with other classes of shares in repayment of capital on liquidation.

If authorised by its articles a company may issue REDEEMABLE PREFERENCE SHARES, as to which *see post*, § 6 (*l*).

Every share in a company is on an equal footing except in so far as the rights attaching thereto are expressly modified by the memorandum and articles of association and the terms of issue. A preference as to dividend does not of itself exclude other rights, *e.g.*, to share in surplus assets on a winding-up. It has, however, been held that where the articles of a company set out the rights attached to a class of shares to participate in profits while the company is a going concern or to share in the property of the company in liquidation, *primâ facie* the rights so set out are exhaustive. The burden of proof that preference shareholders have any further rights is on them and depends upon a true construction of the articles (*Re Isle of Thanet Electricity Supply Co. Ltd.*).

(b) Ordinary Shares

Ordinary shares entitle the holders to the divisible profits remaining after prior interests (if any) have been satisfied. They may be divided into PREFERRED and DEFERRED ordinary shares, the former carrying a preferential right to a fixed rate of dividend, and the latter being entitled to the whole, or a proportion, of the surplus profits after provision has been made for dividends on all classes of shares having prior rights.

(c) Founders, Deferred or Management Shares

These shares are usually limited in number and are sometimes issued fully paid to the vendors or managers of the business or their nominees, in consideration either of part of the purchase price or of services rendered. Generally, they only rank for dividend after other classes of shares have received specified rates of dividend, when they may be entitled to the whole or a portion of the surplus profits.

As a rule, such shares are of low nominal value, *e.g.* one shilling, and consequently the rate of dividend is often extremely high. This, coupled with the fact that these shares may confer excep tional voting rights, enable the holders to wield a considerable interest in, and control of, the company with comparatively small risk of capital. Unless these shares are available for public subscription, the investing public do not look upon their existence with favour, as they induce a tendency to distribute a high rate of dividend without setting aside adequate reserves.

The allocation of such shares to the vendors in payment for goodwill is unfair to the investing public, as it enables the persons who have sold their goodwill to continue to enjoy the profits arising therefrom. Where such shares are issued, they should be offered proportionately with other classes of shares for public subscription.

Shares which carry the right to the balance of profits after payment of all prior charges, and to any surplus in winding-up, are frequently referred to as 'equity' capital.

(d) The distinction between Stock and Shares

A share in a company is an individual unit of capital and is indivisible. A holding must consist of a number of complete shares, and although there may be two or more joint holders of a share, no fraction of a share can be held or transferred.

Stock consists of capital consolidated into bulk, which can be made divisible in any monetary fractions. It has been aptly termed 'a bundle of shares.' It is customary, where stock has been issued, for the articles of the company to provide for holdings in multiples of one pound sterling only, so as to minimise clerical labour in effecting transfers, calculating dividends, etc.

The chief differences between stock and shares are as follows:

(*a*) Stock must be fully paid up, whereas shares need not be.

(*b*) Stock may be issued or transferred in fractional parts (subject to provisions in the articles). A share cannot be divided, but can only be transferred as a complete unit.

(*c*) Each share must be distinguished by a separate number until all the shares of the class in question are fully paid and rank *pari passu* for all purposes (§ 74); stock need possess no distinguishing numbers.

A company cannot issue stock in the first instance; if it wishes to issue stock it must first issue shares, and then convert them into stock when they are fully paid. Many large concerns whose shares are actively dealt in on the Stock Exchange have converted their shares into stock in order to economise in clerical labour when shares are transferred. The saving in labour will readily be seen when it is realised that a sale of, say, 10,000 shares having distinctive numbers, might involve the entry of numbers which, owing to their not running consecutively, would fill the back of the share certificate. These numbers would have to be written on the transfer in the old member's account, in the new member's account, and on the new share certificate, etc., whereas in the case of stock only the monetary value would have to be shown.

(e) Shares of no Par Value

As has been seen, the memorandum of association of a company must state the amount of the share capital with which the company is registered and the number of shares into which such capital is divided. Each share is of a fixed amount, which is called the 'nominal' or 'par' value, and it has always been a fundamental principal of company law in this country that every share must have a nominal value.

In the United States of America and other countries, however, shares of 'no par value' have been quite common for many years, and there has recently been growing support for amendment of the Companies Act, 1948 to permit the issue of similar shares in this country. Accordingly, in December 1952, the Board of Trade appointed a committee—the Gedge Committee—to report what amendments should be made for this purpose, having due regard to the need for safeguards for investors and for the public interest.

In the report of this Committee, which was published in April 1954, the following principal justifications for the proposed change are adduced:

1. The present system of issuing shares with a fixed nominal value may cause confusion, since many small investors are apt to think that because a share has a nominal value of say £1, it must necessarily be worth £1, which is often very far from being the case.

2. Where shares have a nominal value dividends are usually expressed as a percentage thereof. Frequently, the capital employed is far greater than the nominal amount of the issued share capital, owing to large amounts of profits being retained and used in the business, and a dividend which may be quite moderate when considered in relation to the capital actually employed in the business may appear to be unduly high when expressed as a percentage of the nominal capital. If companies were permitted to issue shares of no par value, dividends would be declared at so much per share, and the illusion of an excessively high *rate* of dividend, which is liable to evoke a good deal of irresponsible criticism, would be avoided.

The Gedge Committee made, *inter alia*, the following recommendations:

1. Both public and private companies should be permitted to issue *ordinary* shares of no par value.

2. It would be unwise to issue *preference* shares of no par value because 'a fixed dividend must have a relation to the sum on which it is paid' and also because 'the repayment of a fixed sum in a winding-up' is inconsistent with the concept of no par value.

3. Companies should be allowed, by special resolution, to convert their ordinary shares having a nominal value (whether fully paid or not) into shares of no par value; or vice versa, provided that the no par value shares to be converted were fully paid.

4. Where a company has shares of no par value, the total proceeds of a cash issue would have to be credited to a 'stated capital account' and should not be distributable.

5. Where an issue has been made for a consideration other than cash, a sum equal, in the opinion of the directors, to the value of the consideration would also have to be credited to the stated capital account.

Given these safeguards, the committee concluded that shares of no par value would be neither more nor less open to abuse than shares having a nominal value.

At the time of writing no steps have been taken by the Government to implement the committee's recommendations.

§ 6. The Application and Allotment of Shares

(a) Application Letters

When the directors of a public company decide to issue shares, forms of *application letters* are sent out with a *prospectus* to those persons who are considered most likely to subscribe, or the form may be printed at the foot of the advertisements of the prospectus.

In the great majority of cases subscribers are required to remit the amount payable on application (which, under the Companies' Act, must not be less than 5 per cent. of the nominal value of the shares) direct to the company's bankers, who may or may not issue formal receipts therefor. (Where permission to deal in the securities on the London Stock Exchange is applied for, the council of the Stock Exchange require not less than 25 per cent. of the nominal value to be paid on application.)

(b) Application and Allotment Sheets

A separate banking account should be opened for the issue. Each day the company will obtain from the bank the statement of receipts and the application letters, and these will be entered up immediately on *application and allotment sheets*, a form of which is given on p. 210.

Each application letter will be numbered in consecutive order, as received, and the name, address and description of the applicant, the number of shares applied for, and the amount paid on application, will be entered on the application and allotment

sheet. As soon as the lists are closed, and it is ascertained that the minimum subscription (where applicable) has been subscribed, the directors will proceed to allot the shares, and minutes of all allotments will appear in the directors' minute book. The application and allotment sheets should also be initialled by one of the directors at the point to which allotments have been made. The number of shares allotted and the distinctive numbers of such shares (if any), together with the amount payable on allotment, will be entered in the columns provided for that purpose.

No allotment of shares or debentures is permissible in pursuance of a prospectus issued generally, and no proceedings on applications so made, can be taken until the third day after that on which the prospectus is first so issued, or such later time (if any) as may be specified in the prospectus. This time is referred to in the Act as 'the time of the opening of the subscription lists' (§ 50).

Illustration

APPLICATION AND ALLOTMENT SHEET

Number of Application	Date Received	NAME	ADDRESS	cript	No. of Shares applied for	Allotment				Amount Due and Paid on Allotment				Calls paid in advance	Amount returnable (if any)	Share Ledger Folio	No. of Share Certificate	Remarks
						No. of Shares allotted	Distinctive No. of Shares From	To	Amount	payable.	Date paid	Cash Book Folio	Amount paid					

(c) The Minimum Subscription

In order that prospective applicants for shares may be able to determine whether or not the company is raising enough capital for its immediate purposes, and to prevent the company from going to allotment if such capital is not raised, Section 47 lays down that, *in the case of a first allotment of shares* offered to the public for subscription, no allotment shall be made unless the amount stated in the prospectus as the minimum amount which, in the opinion of the directors, must be raised by the issue of share capital in order to provide for the matters set out below, has been satisfied, and the amount payable on application for the amount so stated has been paid to and received by the company. This amount is called the MINIMUM SUBSCRIPTION.

The matters to be provided for by the minimum subscription are:

(1) the purchase price of any property to be acquired which is to be defrayed in whole or in part out of the proceeds of the issue;

(2) any preliminary expenses payable by the company, and any commission so payable to any person in consideration of his agreeing to subscribe for, or of his procuring or agreeing to procure subscriptions for, any shares in the company;

(3) the repayment of any moneys borrowed by the company in respect of any of the foregoing matters;

(4) working capital.

This amount must be stated in the prospectus and is reckoned exclusively of any amount payable otherwise than in cash.

The amount payable on application must not be less than 5 per cent. of the nominal amount of the share. A cheque received in good faith is regarded as payment.

The provisions relating to minimum subscription do not apply to private companies, which are prohibited from making any invitation to the public to subscribe, nor to public companies which secure their capital without the issue of a prospectus.

If the minimum subscription is not received within forty days of the issue of the prospectus, the application money must be returned, and if such a return is not made within forty-eight days of the issue of the prospectus, the directors are personally liable to repay the money with interest at the rate of 5 per cent. per annum.

Although the details of the minimum subscription must be stated in every prospectus, the restrictions on allotment in respect thereof do not apply in the case of allotments subsequent to the first allotment of shares offered to the public for subscription.

Where a prospectus states that application has been or will be made for permission to deal on any stock exchange, any allotment thereunder is void if permission has not been applied for before the third day after the first issue of the prospectus, or, if permission is refused, before the expiration of three weeks from the date of the closing of the subscription list, or such longer period, not exceeding six weeks, as may, within the said three weeks, be notified to the applicant for permission by or for the stock exchange.

If permission is not so applied for, or is refused, the application money must be repaid. If not repaid within eight days, the directors become personally liable to repay it with interest at 5 per cent. per annum from the expiration of the eighth day.

So long as the company may become liable to repay it, the money must be kept in a separate banking account (§ 51).

(d) Letters of Allotment and Regret

In the event of the issue being over-subscribed, the directors must decide the basis upon which the allotment is to be made—whether by the selection of all applications for over, say, 100 shares, or rateably to all applications; or by a differential allotment, *e.g.*, all under 100 shares in full; from 100—1,000 shares, 50 per cent.; over 1,000 shares, 30 per cent. The course to be adopted will depend upon the nature of the business, and the policy of the directors. Where, for example, the issue is in respect of a departmental store, it would be an advantage to secure as large a number of individual shareholders as possible, as each shareholder is a potential customer, whereas in the case, say, of a ship-building company, the preferential allotment to the applicants for the largest number of shares would save clerical labour.

Where allotment is made of less than the number of shares applied for by an applicant the amount overpaid on application would be deducted from the sums

payable by him on allotment and call. In the case of an applicant who receives no allotment whatever, the application money must be returned to him in full. It is on account of these possible adjustments, and also the fact that the contract to take shares is not complete until the offer has been accepted by notification of allotment that no entry is made in the financial books until the allotment has been made.

Upon allotment a letter of allotment is sent to the applicant setting out the number of shares allotted to him and the amount payable. A letter of regret is sent to those to whom no shares have been allotted.

When the bank statement or pass book (which will usually, and should always in such cases for convenience, be in loose leaf form) is received from the bankers each day, the amounts received on application and allotment will be entered in the cash book, and also in the columns provided for that purpose on the application and allotment sheets. The details will be inserted each day in an inner column of the cash book, and the totals extended into the outer column. Where the issue is a large one, a separate cash book should be used, the daily totals only being carried into the general cash book. After allotment the items will be posted in detail to the credit of the shareholders' cash accounts in the share ledger, and in total to the credit of the Application and Allotment Account in the general ledger. Assuming the shares are issued at par, this account will be debited with the full amount payable on application and allotment, and Share Capital Account credited.

In some cases, the cash columns in the application and allotment sheets are used as the detailed cash account, and only the totals entered in the general cash book.

(e) Vendors' and Signatories' Shares

The shares subscribed for by the signatories to the memorandum and articles of association do not require to be specifically allotted, but should, nevertheless, be entered on the application and allotment sheets in the first instance. As regards shares issued to vendors and others for a consideration other than cash, when these are allotted they should be entered on a separate application and allotment sheet so as to avoid their being confused with shares issued for cash. When shares are issued to nominees of the vendor, a written authority must be obtained from him, authorising the company to allot to such nominees, and containing particulars of their names, addresses and descriptions, and the number of shares to be allotted to each.

(f) Calls

Calls are usually made on dates specified in the prospectus, when one is issued. Where such dates are not specified, subsequent calls are regulated by the provisions in the articles. Table 'A' provides that in such circumstances no call shall exceed one-fourth of the nominal value of the share, or be payable at less than one month from the last call, and each member shall have fourteen days' notice specifying the date of payment. Special articles, however, commonly modify these periods and amounts.

In some cases, columns are provided in the application and allotment sheets for calls, but it is more usual to have separate *call sheets*, which are provided with columns

showing the amount due, and the date and amount of payment. *Call letters* will be issued with forms of bankers' receipts attached calls being payable direct to the company's bankers, in the same way as amounts due on allotment.

In due course share certificates will be made out and issued to the shareholders in exchange for their allotment letters and bankers' receipts for sums due in respect of application, allotment and calls.

(g) The Share Certificate

Within two months of allotment (or within two months after the date of lodgment of any transfer), unless the conditions of issue otherwise provide, the company must complete and have ready for delivery share certificates, indicating the number and class of shares held and the distinctive numbers thereof (where relevant) (§ 80). If all the calls have been made, the shares will be certified as being fully paid. In some cases, however, the date of a call may be some months after that of the allotment, and the certificates would then state that the shares are only partly paid and would give particulars of the payments made, provision being made on the back of the certificate for acknowledgment by the company of the payment of the calls subsequently made.

Where calls are to be made shortly after allotment, the conditions of issue usually provide that share certificates shall not be issued until all calls have been paid, the allotment letters and bankers' receipts constituting the title in the meantime.

(h) Return of Allotments

Under Section 52, whenever a company limited by shares, or limited by guarantee and having a share capital, makes any allotment of its shares, the company must, within one month thereafter, file with the registrar of companies:

(1) a return of the allotments, stating the number and nominal amount of the shares comprised in the allotment, the names, addresses and descriptions of the allottees, and the amount (if any) paid or due and payable on each share; and

(2) in the case of shares allotted as fully or partly paid up otherwise than in cash, a contract in writing constituting the title of the allottee to the allotment, together with any contract of sale, or for services or other consideration in respect of which that allotment was made, such contracts being duly stamped, and a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up, and the consideration for which they have been allotted.

Where such a contract is not reduced to writing, the following particulars, stamped with the same stamp duty as would be payable if the contract were in writing, must be filed with the registrar:

1. The number and nominal value of shares issued as paid up otherwise than in cash, and the amount so credited on each.

2. The nature of the consideration, and a brief description of any property, and how the purchase price is to be satisfied in shares, cash, and liabilities assumed.

3. Details of the apportionment of the purchase price over the following heads:—
Freehold property and fixed plant and machinery and other fixtures thereon;
Leasehold property;

Fixed plant, and machinery on leasehold property (including tenants', trade and other fixtures);
Equitable interests in freehold or leasehold property;
Loose plant and machinery, stock-in-trade and other chattels (no plant and machinery not in an actual state of severance should be included here);
Goodwill and benefit of contracts;
Patents, designs, trade marks, licences, copyrights, etc.;
Book and other debts;
Cash in hand and at bank on current account, bills, notes, etc.;
Cash on deposit at bank or elsewhere;
Shares, debentures and other investments;
Other property detailed.

(i) Journal entries relating to the issue of Shares

Upon each occasion on which an allotment of shares is made, an entry should be made in the journal, debiting an Application and Allotment Account with the amount payable on application and allotment in respect of the shares so allotted, and (assuming the shares are issued at par) crediting Share Capital Account, reference being made to the minutes of allotment and to the pages in the application and allotment book, where the details are shown. If more than one class of capital is being issued, separate accounts must be opened in the ledger for each class.

Similar entries must be made debiting the vendor or other persons, and crediting Share Capital Account, in respect of all shares issued for a consideration other than cash, reference being made to the minutes of allotment and to the contract under which the shares are issued.

When calls are made, an entry must be made debiting Call Account and crediting Share Capital Account with the total amount due in respect of the call.

(j) Shares issued at a premium

A company may issue shares at a premium, *i.e.*, for an amount in excess of their nominal value. Such an issue might be made by a successful company which has paid high dividends on its existing capital and whose shares, as a consequence, already stand at a premium on the market. When shares are issued at a premium, whether for cash or otherwise, the premium must be credited to an account called 'the Share Premium Account' (§ 56). The amount so credited to this account can only be applied in one of the following ways, pending which it must remain in the account:

1. Subject to the confirmation of the Court, in a scheme for reduction of capital, as if it were paid up share capital of the company (*see post* § 19).

2. In paying up unissued shares of the company to be issued to the members as fully paid bonus shares.

3. In writing off:

(*a*) preliminary expenses; or

(*b*) the expenses of, or commission paid or discount allowed on, any issue of shares or debentures of the company.

4. In providing for the premium payable on the redemption of redeemable preference shares or debentures of the company.

Any amount received as a premium on shares issued before 1st July, 1948, is subject to the above provisions if it forms an identifiable part of the company's reserves at that date (§ 56).

The premium is usually payable with the instalment due on allotment, and where this is so the journal entry for allotment must show the amount payable in respect of premium, which must be credited direct to the Share Premium Account, only the proportion of the amount due representing a payment on account of the nominal value of the shares being credited to Share Capital Account.

Illustration

On 30th April, a company goes to allotment, and the following shares are allotted:

80,000 Ordinary Shares of £1 each issued at 22s. 6d. per share;

50,000 5 per cent. Preference Shares of £1 each, issued at par.

The ordinary shares are payable 2s. 6d. on application, 5s. (including the premium) on allotment; 5s. one month after allotment and 10s. three months after allotment. The preference shares are payable 2s. 6d. on application, 2s. 6d. on allotment, 5s. one month after allotment, and 10s. three months after allotment. Make the journal and cash book entries recording these transactions.

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				£	s.	d.		s.	d.
April	30	Application and Allotment Account (Ordinary Shares)	*Dr.*	30,000	0	0			
		To Sundries							
		Ordinary Share Capital Account					20,000	0	0
		Share Premium Account					10,000	0	0
		Being 2s. 6d. on application and 5s. on allotment (2s. 6d. thereof being premium) on 80,000 Ordinary Shares of £1 each, allotted as per minute of this date.		£30,000	0	0	£30,000	0	0
April	30	Application and Allotment Account (Preference Shares) . .	*Dr.*	12,500	0	0			
		To Preference Share Capital Account					12,500	0	0
		Being 2s. 6d. on application and 2s. 6d. on allotment of 50,000 Preference Shares of £1 each, allotted as per minute of this date							
May	31	First Call Account (Ordinary Shares)	*Dr.*	20,000	0	0			
		To Ordinary Share Capital Account					20,000	0	0
		Being First Call of 5s. on 80,000 Ordinary Shares of £1 each.							
May	31	First Call Account (Preference Shares)	*Dr.*	12,500	0	0			
		To Preference Share Capital Account					12,500	0	0
		Being First Call of 5s. on 50,000 Preference Shares of £1 each.							
July	31	Final Call Account (Ordinary Shares) . .	*Dr.*	40,000	0	0			
		To Ordinary Share Capital Account					40,000	0	0
		Being Final Call of 10s. on 80,000 Ordinary Shares							
July	31	Final Call Account (Preference Shares)	*Dr.*	25,000	0	0			
		To Preference Share Capital Account					25,000	0	0
		Being Final Call of 10s. on 50,000 Preference Shares.							

It will be noted that a single journal entry is made combining the amounts payable on application and allotment. Some accountants prefer to make these entries separately, but the above course is advocated on two grounds, viz., (1) the contract to take shares is not complete until allotment, and the offer may be withdrawn at any time prior to that date, and (2) applications may not be accepted, or accepted only for a portion of the shares applied for.

CASH BOOK

April	30	To Application and Allotment Accounts: 2s. 6d. per share on Application for 80,000 Ordinary Shares	10,000
		50,000 Preference Shares .. .	6,250
May	2	.. Application and Allotment Accounts: Ordinary Shares - 5s. per share due on allotment on 80,000 shares .	20,000
		Preference Shares – 2s. 6d. per share due on allotment on 50,000 shares	6,250
June	2	First Call Accounts: Ordinary Shares, 5s. per share on 80,000 shares	20,000
		Preference Shares, 5s. per share on 50,000 shares	12,500
Aug.	1	.. Final Call Accounts: Ordinary Shares 10s. per share on 80,000 shares . ..	40,000
		Preference Shares, 10s. per share on 50,000 shares	25,000

(k) Shares issued at a discount

If its existing shares are quoted below their par value on the market, it would be impracticable for a company to obtain subscriptions for an issue of further shares of the same class at the full nominal value, and it may be thought expedient to issue shares at a discount.

The issue of shares at a discount is illegal, however, except under the provisions of Section 57, which enacts that:

(1) the shares to be issued at a discount must be of a class already issued;

(2) the company must authorise the issue by a resolution passed in general meeting, and the sanction of the Court must be obtained. In giving its sanction, the Court may impose such terms and conditions as it thinks fit;

(3) the resolution must specify the maximum rate of discount at which the shares are to be issued;

(4) not less than one year must, at the date of the issue, have elapsed since the date on which the company was entitled to commence business;

(5) the shares must be issued within one month after the date of sanction of the Court, or within such extended time as the Court permits;

(6) any prospectus issued in connection with the shares must contain particulars of the discount allowed, or of so much of that discount as has not been written off at the date of the issue of the prospectus;

(7) every balance sheet subsequently issued must contain particulars of the amount of the discount so far as it has not been written off (8th Schedule, Pt. I, § 3).

When the issue has been made, Share Capital Account must be credited with the full nominal value of the shares, and a Discount on Shares Account debited with the amount of the discount, cash being debited with the amount received. The Discount on Shares Account should be written off out of profits over a period of years, since it is not represented by value. There is, however, no legal obligation on a company to write off the discount.

(l) Redeemable Preference Shares

Power is given under Section 58, to a company limited by shares, to issue preference shares which are, or at the option of the company are to be liable, to be

redeemed. Apart from the fact that authority must be contained in the articles, the issue of the shares does not differ from any other form of issue, but there must be included in every balance sheet a statement specifying what part of the issued capital consists of such shares, and the earliest date on which the company has power to redeem them (8th Schedule, Pt. I, § 2). Subject to the remarks which follow, the redemption may be effected on such terms and in such manner as may be provided by the articles.

Redeemable preference shares can only be redeemed out of profits which would otherwise be available for dividend, or out of the proceeds of a fresh issue of shares made for the purposes of the redemption. No shares can be redeemed unless they are fully paid.

If the shares are redeemed at a premium, such premium must have been provided for out of the profits of the company or out of the Share Premium Account before the shares are redeemed.

Where any shares are redeemed otherwise than out of the proceeds of a fresh issue, there must, out of profits which would otherwise have been available for dividend, be transferred to a reserve fund to be called the 'Capital Redemption Reserve Fund' a sum equal to the nominal amount of the shares redeemed, and the provisions of the Companies Act, 1948, relating to the reduction of the share capital of a company shall apply as if the capital redemption reserve fund were paid-up share capital of the company. The fund may, however, be used to pay up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

The redemption of redeemable preference shares does not reduce the authorised share capital of the company.

Where a company has redeemed, or is about to redeem, any preference shares, it is empowered to issue fresh shares (of any class) up to the nominal amount of the shares redeemed or to be redeemed, as if those shares had never been issued. If the new issue is made before the redemption of the old shares, no stamp duty is payable on the new issue provided the old shares are redeemed within one month thereafter. If the redemption is delayed beyond the month, the appropriate duties will have to be paid.

Notice of the redemption of redeemable preference shares must be given to the registrar of companies within one month of the redemption (Section 62).

The purpose of the capital redemption reserve fund is to prevent a reduction of capital, as will be seen from the following simple statements.

A company issued 10,000 redeemable preference shares of £1 each, redeemable at par, and 2 ordinary shares of £1 each. On the date for redemption of the shares the company's balance sheet was as follows:

	£		£
Redeemable Preference Shares	10,000	Investments at Cost	10,002
Ordinary Shares	2	Cash .	10,000
Profit and Loss Account .	10,000		
	£20,002		£20,002

Immediately after redeeming the shares, the balance sheet would read—

Ordinary Shares		Investments at cost	10,002
Profit and Loss Account	10,000		

Obviously, £10,000 of the assets was provided by the issue of the preference shares, and if the company could now realise investments and pay a dividend of £10,000, the effect would be to reduce its capital to £2. If there were creditors, they might be severely prejudiced. Accordingly, since £10,000 of the profits have been applied in repaying capital, the profits remaining available for distribution as dividends are reduced by this sum, and the Act requires an equivalent amount to be taken out of Profit and Loss Account and capitalised. The capital redemption reserve fund so created can be reduced, as if it were share capital, by passing a special resolution and obtaining the sanction of the Court, or can be used to pay up bonus shares.

Illustration

The Balance Sheet of a company at December 31st, was as follows:

			£
Authorised and Issued Capital ·		Sundry Assets	84,000
40,000 6% Redeemable Preference Shares of £1 each fully paid	40,000	Cash	30,000
20,000 Ordinary Shares of £1 each fully paid	20,000		
Share Premium Account	5,000		
Profit and Loss Account	28,000		
Liabilities	21,000		
	£114,000		£114,000

By the terms of their issue the preference shares were redeemable at a premium of 5 per cent. on the following January 1st, and it was decided to arrange this as far as possible out of the company's resources subject to leaving a balance of £5,000 to remain to the credit of the Profit and Loss Account. It was also decided to raise the balance of funds required by the issue of a sufficient number of ordinary shares at a premium of 5s. per share.

Show the necessary journal entries and ledger accounts giving effect to the transactions and the Balance Sheet thereafter.

JOURNAL

			£	£
Jan.	1	6% Redeemable Preference Share Capital ... *Dr.*	40,000	
		Premium on Redemption of Preference Shares	2,000	
		To Preference Shares Redemption Account		42,000
		Transferring 40,000 £1 redeemable preference shares redeemable at a premium of 5%.		
		Application and Allotment (Ordinary Shares) *Dr.*	21,250	
		To Ordinary Share Capital		17,000
		" Share Premium Account		4,250
		Issue of 17,000 ordinary shares at premium of 5s. per share.		
		Cash *Dr.*	21,250	
		To Application and Allotment		21,250
		Cash received on issue of 17,000 ordinary shares.		
		Preference Share Redemption Account *Dr.*	42,000	
		To Cash		42,000
		Redemption of 40,000 6% Redeemable Preference Shares at premium of 5%.		
		Profit and Loss Account *Dr.*	23,000	
		To Capital Redemption Reserve Fund		23,000
		Transfer out of profits of amount equal to nominal amount of shares redeemed otherwise than out of the proceeds of a new issue.		
		Share Premium Account *Dr.*	2,000	
		To Premium on Redemption of Preference Shares		2,000
		Providing for premium on redemption out of Share Premium Account.		

LEDGER

6% REDEEMABLE PREFERENCE SHARE CAPITAL

					£
Jan. 1	To Preference Share Redemption Account	40,000	Dec. 31	By Balance b/f ...	40,000

PREMIUM ON REDEMPTION OF PREFERENCE SHARES

					£
Jan. 1	To Preference Share Redemption Account	2,000	Jan. 1	By Share Premium Account	2,000

PREFERENCE SHARE REDEMPTION ACCOUNT

					£
Jan. 1	To Cash	42,000	Jan. 1	By 6% Redeemable Preference Shares	40,000
				„ Premium on Redemption	2,000

ORDINARY SHARE CAPITAL

					£
Jan. 1	To Balance c/f.	37,000	Dec. 31	By Balance b/f . ..	20,000
			Jan. 1	„ Application and Allotment	17,000
		£37,000			£37,000
			Jan. 1	By Balance	37,000

SHARE PREMIUM ACCOUNT

		£			£
Jan. 1	To Premium on Redemption of Preference Shares	2,000	Dec. 31	By Balance b/f. . . .	5,000
	„ Balance c/f.	7,250	Jan. 1	„ Application and Allotment .	4,250
		£9,250			£9,250
			Jan. 1	By Balance b/f.	7,250

APPLICATION AND ALLOTMENT (ORDINARY SHARES)

					£
Jan. 1	To Share Capital ...	17,000	Jan. 1	By Cash	21,250
	„ Share Premium	4,250			
		£21,250			£21,250

PROFIT AND LOSS ACCOUNT

		£			£
Jan. 1	To Capital Redemption Reserve Fund ..	23,000	Dec. 31	By Balance b/f. ...	28,000
	„ Balance c/f.	5,000			
		£28,000			£28,000
			Jan. 1	By Balance b/f.	5,000

CAPITAL REDEMPTION RESERVE FUND

					£
			Jan. 1	By Profit and Loss Account	23,000

CASH BOOK

			£				£
Dec.	31	To Balance b/f.	30,000	Jan.	1	By Preference Share Redemption Account	42,000
		" Application and Allotment: Ordinary Shares	21,250			" Balance c/f.	
			£51,250				£51,250
Jan.	1	To Balance b/f.	9,250				

BALANCE SHEET, JANUARY

	£		£
Authorised Capital -- 60,000 Shares of £1 each	60,000	Sundry Asset Cash	84,000
Issued and Paid-up Capital-- 37,000 Ordinary Shares	37,000		
Share Premium Account ...	7,250		
Capital Redemption Reserve Fund	23,000		
Profit and Loss Account .	5,000		
	72,250		
Liabilities	21,000		
	£93,250		£93,250

Note

(1) Since £5,000 is to be carried forward on Profit and Loss Account, 23,000 of the redeemable preference shares can be redeemed out of profit, leaving 17,000 to be redeemed out of the proceeds of a new issue of ordinary shares.

(2) The premium on redemption of the preference shares has been written off against the company's Share Premium Account in accordance with Section 58 (1) (c) of the Companies Act, 1948.

Where it is necessary to realise assets in order to provide the cash for the redemption of preference shares, losses on the realisation of the assets should be written off to Profit and Loss Account (or charged to any reserve which exists to meet such capital losses), but profits on such realisations should be regarded as a capital reserve not available for dividend purposes.

§ 7. Forfeiture of Shares

The articles of a company usually give power to the directors to forfeit shares in respect of which calls are unpaid and overdue, proper notice (Table 'A' prescribes fourteen days) having been given to the defaulting shareholder that unless the calls are paid, his shares will be forfeited. Table 'A' also gives power to forfeit shares for non-payment of any premium on the shares.

When such forfeiture takes place, the Share Capital Account should be debited with the amount CALLED UP in respect of the shares, and Forfeited Shares Account credited. The calls in arrear in respect of these shares will have remained as a debit balance, either on the Application and Allotment Account or Call Account. These unpaid calls should be written off against the Forfeited Shares Account, the credit balance of which will then represent the cash actually received in respect of the shares forfeited.

Until these shares are re-issued, this balance should appear in the Balance Sheet as a separate item under the heading of Forfeited Shares Account.

Forfeited shares can be re-issued as fully paid at any price, so long as the sum received on re-issue, plus the amount received from the original allottee before

forfeiture, make up together at least the nominal value of the shares in question. If, after the re-issue of the shares, there still remains a credit balance on the Forfeited Shares Account, this would represent an amount received by the company in respect of those shares in excess of their nominal value which, it is submitted, should be regarded as a premium on the issue of such shares and transferred to Share Premium Account.

If the forfeited shares were originally issued at a premium which had been paid prior to the forfeiture, the Share Premium Account need not be disturbed as the premium is not, strictly speaking, a payment for the shares themselves, but is rather in the nature of a payment for the right to acquire the shares. Where, however, shares are forfeited for non-payment of instalments which include the premium, so that the premium has not been received by the company, the debit balance in respect of the unpaid premium should be written off against the Share Premium Account.

Illustration (1)

A company has an issued capital of £20,000 in shares of £1 each, fully paid with the exception of 200 shares on which only 10s. has been paid. The latter are forfeited for non-payment of calls, and subsequently re-issued as fully paid at the price of 15s. per share. Show the entries in the company's journal and ledger recording these transactions.

JOURNAL

		£	£
Share Capital Account	*Dr.*	200	
To Forfeited Shares Account . .			200
Being 200 shares of £1 each forfeited for non-payment of calls a per minute dated			
Forfeited Shares Account . . .	*Dr.*		
To Call Account .			
Being calls in arrear, 10s. per share on 200 shares forfeited, now transferred.			
Sundries	*Dr.*		
To Share Capital Account . .			200
Forfeited Shares Re-issued Account . . .		150	
Forfeited Shares Account		50	
Being re-issue of 200 forfeited shares of £1 each as fully paid, at 15s. per share.			

LEDGER

SHARE CAPITAL ACCOUNT

	£		£
To Forfeited Shares Account... . ..	200	By Balance b/f.	20,000
" Balance c/d.	20,000	" Sundries	200
	£20,200		£20,200
		By Balance b/d.	20,000

FORFEITED SHARES ACCOUNT

	£		£
To Call Account	100	By Share Capital Account	200
" Share Capital Account	50		
" Balance c/d.	50		
	£200		
" Share Premium Account .	50	By Balance b/d.	

CALL ACCOUNT

	£		£
To Balance b/f	100	By Forfeited Shares Account	100

FORFEITED SHARES RE-ISSUED ACCOUNT

	£		£
To Share Capital Account	150	By Cash	150

Note

As the whole of the shares in question have been re-issued, the balance of the Forfeited Shares Account, after transferring 5s. per share (the amount necessary to make the price of re-issue up to par) is a premium on the issue of the shares and should be transferred to the Share Premium Account.

It may happen that forfeiture takes place upon failure of the allottee to pay the amount due upon allotment, subsequent calls being due prior to the re-issue of the shares.

Illustration (2)

A company invites applications for 20,000 shares of £1 each, payable 2s. 6d. per share on application, 7s. 6d. on allotment, 5s. per share 2 months after allotment, and 5s. 4 months after allotment. An applicant for 200 shares fails to pay the allotment money, and the shares are forfeited prior to the first call becoming due. After all calls have been made, the forfeited shares are re-issued at par. Show the entries in the company's journal and ledger recording these transactions.

JOURNAL

		£	£
Application and Allotment Account .	*Dr.*	10,000	
To Share Capital Account ...			10,000
Being 2s. 6d. on application and 7s. 6d. on allotment on 20,000 shares of £1 each, allotted as per minute of this date.			
Share Capital Account	*Dr.*	100	
To Forfeited Shares Account			100
Being 200 shares of £1 each, 10s. per share called up, forfeited for non-payment of allotment money as per minute dated			
Forfeited Shares Account . .	*Dr.*	75	
To Application and Allotment Account			
Being allotment money unpaid on 200 shares forfeited, now transferred.			
First Call Account	*Dr.*	4,950	
To Share Capital Account			4,950
Being 1st call of 5s. per share on 19,800 shares, due this day.			
Second Call Account	*Dr.*	4,950	
To Share Capital Account			4,950
Being Second Call of 5s. per share on 19,800 shares, due this day.			
Forfeited Shares Re-issued Account	*Dr.*	200	
To Share Capital Account			200
Being re-issue of 200 forfeited shares, at par.			

LEDGER
SHARE CAPITAL ACCOUNT

	£		£
To Forfeited Shares Account	100	By Application and Allotment Account ...	10,000
" Balance c/d. ...	20,000	" First Call Account	4,950
		" Second Call Account ..	4,950
		" Forfeited Shares Re-issued Account	200
	£20,100		£20,100
		By Balance b/d.	20,000

APPLICATION AND ALLOTMENT ACCOUNT

	£		£
To Share Capital Account	10,000	By Cash on application ..	2,500
		" " on allotment .	7,425
		" Forfeited Shares Account	75
	£10,000		£10,000

FIRST CALL ACCOUNT

	£		£
To Share Capital Account	4,950	By Cash	4,950

SECOND CALL ACCOUNT

			£
To Share Capital Account ..	4,950	By Cash	4,950

FORFEITED SHARES ACCOUNT

			£
To Application and Allotment Account . .	75	By Share Capital Account	100
" Balance c/d.	25		
	£100		
To Share Premium Account	25	By Balance b/d.	25

FORFEITED SHARES RE-ISSUED ACCOUNT

			£
To Share Capital Account	200	By Cash ..	200

Illustration (3)

A company issued a prospectus inviting applications for 200,000 shares of 5s. each at a premium of 1s. 6d., payable as follows :

On application	1s. 0d. per share.	
" allotment	2s. 6d. " "	(including premium).
" first call	2s. 0d. " "	
" second call	1s. 0d. " "	

Applications were received for 300,000 shares, and allotments made *pro rata* to the applicants for 240,000 shares, the remaining applications being refused. Money overpaid on application was employed on account of sums due on allotment.

X, to whom 400 shares were allotted, failed to pay the allotment money, and on his subsequent failure to pay the first call, his shares were forfeited. Y, the holder of 600 shares, failed to pay the two calls, and his shares were forfeited after the second call had been made.

Of the shares forfeited, 800 were re-issued to Z, credited as fully paid, for 4s. 6d. per share, the whole of X's shares being included. Show the journal entries required to record the above forfeitures and re-issue.

JOURNAL

			£	£
Share Capital Account		*Dr.*	80	
To Forfeited Shares Account				80
Forfeiture of 400 shares allotted to X, 4s. per share called up, for non-payment of balance due on allotment and first call, per minute of this day.				
Forfeited Shares Account . .		*Dr.*	56	
Share Premium Account			30	
To Application and Allotment Account				46
First Call Account				40
Amounts unpaid by X on shares forfeited, viz.--				
Due on application and allotment—400 shares—2s. each		£40		
Less paid on application for 480 shares—1s. each		24		
		16		
Add Premium on 400 shares—1s. 6d. each		30		
First Call on 400 shares—2s. each ..		40		
		£86		
Share Capital Account		*Dr.*	150	
To Forfeited Shares Account				150
Forfeiture of 600 shares allotted to Y for non-payment of 1st and 2nd calls, per minute of this day.				
Forfeited Shares Account		*Dr.*	90	
To 1st Call Account . . .				60
2nd " " .. .				30
Amounts not paid by Y on shares forfeited.				
Z		*Dr.*	180	
Forfeited Shares Account			20	
To Share Capital Account				200
Re-issue of 800 forfeited shares for 4s. 6d. each, credited as fully paid as per minute of this day.				
Forfeited Shares Account		*Dr.*	44	
To Share Premium Account . ..				
Transfer of capital profit on re-issue of shares, viz.--				
400 shares formerly held by X :				
Amounts received from X	£24			
	90			
	114			
Less credited as paid	100			
		14		
400 shares formerly held by Y :				
Amount received from Y, 3s. 6d. per share .	£70			
" " " Z	90			
	160			
Less Premium included in allotment money .	30			
	130			
Less credited as paid	100			
		30		
		£44		

Note

The balance remaining on Forfeited Shares Account, £20, is the amount paid by Y on application and allotment for the balance of 200 shares, ignoring the premium paid thereon (which is in the Share Premium Account).

§ 8. The Share Books

(a) The Share Ledger

This book, which is often arranged so that it can be utilised as the register of members, contains an account for each shareholder, showing the number of shares he has acquired, the number he has transferred, and the balance standing in his name. If shares are issued as partly paid up, cash columns must be provided to record the payment of calls. As soon, however, as the shares become fully paid, the cash columns will no longer be necessary. Where there are different classes of shares, there must either be separate share ledgers for each class, or separate columns must be provided in order to distinguish between the various classes of shares held by each member.

(b) The Form of Transfer

This is regulated by the articles of the company. Transfers must be in writing (Section 75). Clause 23 of Table 'A' provides for transfers to be effected by an instrument in writing in any usual or common form or any other form which the directors may approve.

The transfer, filled in and signed by the transferor, together with the share certificate, is handed to the transferee in return for the consideration. The latter will complete the transfer with his signature, and send it, duly stamped, to the company for registration.

Except where the nominal stamp duty of 10/- is payable in the circumstances usually outlined on the back of the transfer form, the following *ad valorem* duties are payable (*Finance Act*, 1947, § 52):

Where the amount of the consideration does not exceed	£5	...	2/-
	10	...	4/-
	15	...	6/-
	20	...	8/-
	25	...	10/-
For every additional £25 or fractional part up to	300	...	10/-
For every additional £50 or fractional part ...		...	£1

When a shareholder desires to transfer part only of the number of shares represented by the certificate in his possession, he should forward the certificate with the form of transfer to the secretary of the company, who will certify on the transfer (which he will return) that a certificate for at least the number of shares sold has been lodged with the company. This is termed a *certified transfer* and can be safely taken by the transferee as good delivery (Section 79). The secretary of the Share and Loan Department of the Stock Exchange will also certify transfers of quoted shares. Where he does so he immediately hands the certificate and particulars to the company.

Upon the completion of the transfer by the transferee, it is lodged with the company for registration, and on its being passed by the directors, a certificate for the number of shares transferred will be issued to the transferee, and a balance certificate for the number of shares retained will be issued to the transferor.

Illustration

REGISTER OF MEMBERS AND SHARE LEDGER

Name *Date of entry as a member,* 19 Notes

Address and Occupation *Date of ceasing to be a member,* 19

Shares Acquired.								Cash Payable on Shares.				Cash Paid on Shares.				Shares Transferred.						
No. of Allotment.	No. of Transfer.	Date of Allotment or Entry of Transfer.	No. of Shares Allotted or Transferred.	Distinctive Numbers (Inclusive).		Transferor's Folio (if so acquired).	Total Value of Shares held.	Date when called.	Description of Payment or No. of Call.	Amount per Share.	Total Amount.	Date when due.	Date of Payment.	Cash Book Folio.	Amount	No. of Transfer.	Date of Entry of Transfer.	Number of Shares Transferred.	Distinctive Numbers (Inclusive).		Transferee's Folio.	Total Value of Shares Transferred.
				From	To														From	To		

The amounts payable on application and allotment and calls by each shareholder will be posted from the application and allotment and call sheets to the debit of that shareholder's cash account in the share ledger, and cash received from him in respect thereof will be credited to his cash account in the share ledger from the shareholders' cash book.

The debit balance (if any) on the cash columns of the shareholder's account in the share ledger will represent the amount due by him in respect of calls, etc., unpaid, whereas a credit balance will represent calls paid in advance. At balancing periods the balances of these cash columns will be extracted, and the total thereof agreed with the balance of the call accounts representing calls in arrear or calls paid in advance.

If dealings in the shares are numerous, it is convenient to add a 'Balance' column to show exactly what the holding is at any time

(c) The Register of Transfers

This book is utilised to record particulars of all transfers registered by the company, and from it the postings are made into the share ledger. In some cases it is the practice to dispense altogether with the register of transfers, the transfers themselves being filed, and the postings made direct from them into the share ledger. This, of course, saves a considerable amount of labour, and possesses the possible advantage that error is less likely to arise, since the posting is made direct from the original document, instead of the particulars being first copied into a subsidiary book. At the same time the absence of the register is inconvenient for purposes of reference and check on the transfer fees received. It is usual for the directors, after passing the transfers to any given date, to initial the transfer book accordingly; this advantage is also lost when no register is kept.

The following is a convenient form for general purposes:

Illustration

REGISTER OF TRANSFERS

		Transferor.				Distinctive Numbers.		Transferee.				
No. of Certifi	re Fo	Name.	Address.	esc tio	Number of Shares Transferred.	From	To	Name.	Address	Des tı	No. of New Certificate.	Remarks

(d) The Share Warrant Register

It is a practice for certain companies, particularly those having foreign shareholders, to issue *share warrants to bearer*, instead of certificates which require registration. Since these share warrants are in the nature of negotiable instruments, a precise record must be kept of all those printed, and of all those issued, and to whom. For this purpose a *share warrant register* will be used, to show to whom the warrants were issued, the numbers of such warrants, and the distinctive numbers (if any) of the shares to which they relate.

Share warrants can only be issued in respect of shares which are fully paid (Section 83). They must be stamped with a duty equal to three times the transfer duty on the nominal value of the shares (*Stamp Act*, 1891, § 107).

In order to enable the holders of share warrants to attend and vote at meetings of the company, the date of the proposed meeting must be notified by advertisement, and the holders will be required to lodge their share warrants at the company's registered office on or before a specified date prior to the meeting (such period being in accordance with the terms of the articles). This minimises the risk of persons who

might have improperly obtained temporary possession of the warrants attempting to obtain privileges only to be enjoyed by *bona fide* members.

In connection with the system of exchange control now in operation, all bearer securities, such as share warrants, are required to be deposited with an approved depository, usually a bank.

§ 9. Preliminary and Formation Expenses

These comprise the expenses incidental to the creation and flotation of a company and the fulfilment of the statutory requirements precedent to the commencement of business. The following items are usually included therein:

1. Stamp duties and fees on the nominal capital, and stamps on the contracts transferring the assets.
2. The law costs of preparing the prospectus, memorandum and articles of association and contracts, and of the registration of the company.
3. Accountants' and valuers' fees for reports, certificates, etc.
4. Cost of printing memorandum and articles of association.
5. Cost of the company's seal, statutory books, etc.

In addition to preliminary expenses, the following expenses incurred in connection with the issue of shares and debentures, must be stated separately in the balance sheet of the company (8th Schedule, Pt. I, § 3):

(i) Any expenses incurred in connection with any issue of share capital or debentures;
(ii) Any commission in respect of any shares or debentures;
(iii) Any discount on debentures;
(iv) Any discount on shares.

The preliminary and formation expenses are sometimes borne entirely by the company, and sometimes by the vendors of the business to the company, or apportioned between these parties, the expenses up to allotment being payable by the vendors, and the expenses afterwards by the company. Care must be taken to see that the company is only charged with expenses properly payable by it.

This expenditure is, strictly speaking, of a capital nature, but as it is unrepresented by assets, it is usual to write it off as soon as possible out of revenue. The balance not written off must be carried forward in the balance sheet, underwriting and other commission on the issue of shares, and also costs of issue of shares or debentures, being shown separately.

(a) Underwriting Commission

This is an amount payable to persons who undertake to subscribe for shares comprised in a public issue, to the extent that they are not subscribed for by the public. An underwriting contract is therefore in the nature of a speculation. If the public respond to the extent of applying for the whole of the shares, the underwriters receive their commission, and do not have to take up any shares. If the public apply for only part of the shares, the underwriters receive their commission but have to take up the shares not subscribed for in proportion to their contracts. It is usual for

the underwriters to make formal application for the shares they underwrite, on the understanding that allotment will be made only to the extent to which the public do not apply for shares.

The provisions mentioned in § 6 (*c*) *ante* regarding repayment of application money where a stock exchange quotation is refused, apply also to shares underwritten; the allotment is void (Section 51 (6)).

Illustration (1)

The Andorra Engineering Company, Ltd., issued a prospectus inviting applications for 100,000 shares. A underwrote 40% of the total, B 30%, and C 30%, in return for a commission of 5%. A and B also applied firm for 20,000 shares each. The public made applications for 40,000 shares apart from the applications by A and B. There were thus 20,000 shares to be taken up by A, B and C in the ratio in which they had underwritten the issue, A taking 8,000, B 6,000, and C 6,000. The commission received, of course, would be on the total amount underwritten, viz., A £2,000, B £1,500, and C £1,500.

The underwriters may enter into subsidiary agreements with sub-underwriters in order to spread the risk. When such a course is contemplated, the principal underwriters are frequently paid an additional commission, termed an 'over-riding' commission, since they would generally have to pay to the sub-underwriters underwriting commission at the same rate as they themselves have received. The payment of over-riding commission by the company is justified on the ground that the latter is then able to effect an underwriting contract with only one or two underwriters instead of a number, the underwriters usually remaining responsible for the obligations entered into in respect of the subsidiary agreements.

Illustration (2)

X Ltd. issues a prospectus inviting applications for 100,000 shares of £1 each, and enters into a contract with M, who undertakes to underwrite the whole issue at 4 per cent., with an over-riding commission of 1 per cent. M places underwriting with the following sub-underwriters:—

A 40,000 shares, B 30,000 shares, C 20,000 shares.

In this case, the underwriting and over-riding commissions are apportioned as follows—

A 4% on £40,000 = £1,600; B 4% on £30,000 = £1,200; C 4% on £20,000 = £800; and M 4% on the balance of £10,000, plus 1% on £100,000 = £1,400.

Sometimes underwriters apply 'firm' for a number of shares; that is, they request the shares so applied for to be allotted to them, whatever the response of the public to the issue may be. If the issue is under-subscribed, each underwriter may still be called upon to fulfil his obligations under the underwriting contract, irrespective of 'firm' applications, unless the contract provides for relief to be given for firm applications, in which event the number of shares to be taken up under the contract by each underwriter is reduced by the number of shares taken 'firm.'

(b) Commission on placing Shares

This is an amount payable to parties who introduce to the company persons willing to become members, and to take up shares accordingly. This commission, therefore, differs from underwriting commission in so far as it is not a speculative transaction, and is only paid in the event of capital being introduced.

The payment of commission to persons in consideration of their agreeing to subscribe for shares, or procuring or agreeing to procure subscriptions, is authorised by Section 53. The amount or rate per cent. of the commission (which must not exceed 10% of the price at which the shares are issued) must be authorised by the articles of association, and disclosed in the prospectus, or the statement required to be filed with the registrar in lieu thereof, and in any invitation to subscribe for shares not being a prospectus.

This commission is usually payable in cash, but is sometimes satisfied by the issue of fully-paid shares, or partly in one form and partly in the other.

Under the Eighth Schedule to the Companies Act, 1948, Part I, paragraph 3, the total amount of commission paid in respect of any shares or debentures, or so much thereof as has not been written off, must be stated under a separate heading in every balance sheet of the company until the whole amount has been written off.

§ 10. Mortgages and Debentures

(a) Definition of Mortgage

A mortgage of freehold property is of the nature of a long lease (3,000 years) granted by one person (the mortgagor) to another (the mortgagee) as a security for money lent, with a condition that if the money is repaid on a certain day with interest at an agreed rate, the demise made in favour of the mortgagee shall automatically terminate. This right to have the mortgage terminated is called the 'equity of redemption.'

In the case of leasehold property, the term of the lease to the mortgagee is for the unexpired portion of the mortgagor's lease less 10 days.

A second mortgage may be given for one day longer than the first mortgage.

A mortgage must not be confused with an ordinary lease; in the case of a mortgage, the mortgagor remains in possession of the property so long as he fulfils the terms of the mortgage deed, whereas in an ordinary lease the lessor quits possession.

In a mortgage, both the lender and borrower have a legal estate, that of the former being in the nature of a leasehold which he can assign at will, and that of the latter a fee simple or leasehold interest (as the case may be) upon which he can sue, subject to the mortgage.

A limited company can raise money under similar conditions by a charge upon chattels, as well as upon land. A mortgage can therefore be stated shortly as a conditional transfer of property made for the purpose of securing repayment of a loan with interest. Until default is made in the terms of the mortgage, either as regards the payment of interest or the repayment of principal, or in any other way, the mortgagor (*i.e.*, the borrower) retains possession and use of the property, but as he does not possess an unencumbered title thereto he cannot convey it without the consent of the mortgagee (*i.e.*, the lender).

The entries in a company's books when money is borrowed on mortgage will be a debit to cash and a credit to Loan on Mortgage Account. A note should be made in the ledger account of the asset charged under the mortgage. The proper entry

must be made in the register of charges. In the balance sheet the loan must be shown separately on the liabilites side as loan on mortgage (*see* Eighth Schedule, Part I, paragraph 9). Sometimes, however, the amount of the mortgage is deducted from the value of the asset charged, and only the balance extended.

Where a mortgage is repaid out of profits, it is desirable, if not imperative, to transfer from Profit and Loss Account to reserve an amount equal to the cash so applied, otherwise if dividends are declared up to the full amount of the balance of Profit and Loss Account before such a transfer has been made, working capital may become depleted. If, of course, reserves and liquid capital are already adequate, no transfer will be necessary.

(b) Definition of Debenture

A debenture is a written acknowledgement of a debt by a company, usually under seal, and generally containing provisions as to payment of interest and repayment of principal. It may be either a simple or naked debenture, carrying no charge on assets, or a mortgage debenture, carrying either a fixed or floating charge on some or all of the assets of the company, either including or not, as the case may be, the uncalled capital of the company.

A fixed charge is a mortgage, as already described, on specific assets, and the company therefore loses the right to deal with the assets charged, except with the consent of the mortgagee. A floating charge, on the other hand, is not really a mortgage at all, since the nature of the charge is that so long as the company continues to carry on its business and observe the terms of the charge, the directors are entitled to deal in any way they please in the ordinary course of business with the assets of the company, and may even make specific charges of property which, subject to the terms of the floating charge given, will have priority to the floating charge. The floating charge is a charge on a class of assets, present and future, which in the ordinary course of business is changing from time to time, and attaches to the property included therein in preference to the general liabilities of the company, *i.e.*, to its liabilities to creditors not secured by specific charge at the moment the floating charge becomes fixed. The floating charge hovers over or 'floats' with the assets, until some event happens (*e.g.*, default in repaying principal or interest) which crystallises the charge into a fixed one.

Under Section 95, all mortgages and charges affecting the property of a company, as defined in that section, must be registered within twenty-one days after the date of creation, with the registrar of companies, otherwise they will be void against the liquidator and any creditor of the company, so far as the security comprised in the charge is concerned. If so rendered void, the principal moneys will immediately become repayable.

Debentures may either take the form of bonds to bearer, or they may be registered in the names of the holders, transmission being by transfer. In such a case, a debenture ledger should be kept, similar in form to the share ledger previously described, in order to record the necessary particulars. Debenture stock may also be issued, the

distinction between this and registered bonds being similar to the distinction between stock and shares mentioned earlier in this chapter. Unlike capital stock, debenture stock can be issued in the form of stock straight away without first being issued in some other form, and may even be issued at a discount.

Where a fixed charge is given, the charge will be in the names of trustees, who may then issue debenture stock for sub-multiples of the amount. In the case of a floating charge it is also common for two or more persons to be appointed as trustees for the debenture holders, for the purpose of looking after their interests, and taking any action that may be necessary to protect their security.

A company may make more than one issue of debentures, in which case issues subsequent to the first may rank *pari passu* (*i.e.*, on an equal footing) with the original issue, or may confer a charge, subject to and following the first, according to whether the original debentures contained clauses allowing or forbidding subsequent *pari passu* issues. Where the debentures carry different priorities, they are usually designated first debentures, second debentures, etc.—a higher rate of interest being payable on those of lower rank to compensate for the lower degree of security.

A company can only issue debentures up to an amount within the limits of its borrowing powers, as set out in its memorandum and/or articles of association. In the case of a trading company, such powers are implied unless there are provisions to the contrary in the memorandum or articles. Debentures attract a stamp duty of 5s. per cent. on the par or redemption price, whichever is higher.

The contractual rate of interest is payable on the debentures whether the company makes profits or not, since the charge given covers principal and interest. Income tax is deductible from the interest payable under the usual rules.

Entries in the books of a company on an issue of debentures are similar to those on an issue of shares, Instalment Accounts being debited with the various instalments as they become due, and Debentures Account credited. If debentures are issued to the vendor as part of the consideration for a business acquired by the company, the Vendor's Account is debited and the Debentures Account credited therewith. The proper entry must also be made in the register of charges kept by the company.

(c) Debentures issued at a premium

When debentures are issued at a premium, the Debentures Account should be credited only with the nominal amount of the debentures, the premium being credited to Debenture Premium Account. The Companies Act, 1948, does not specify the manner in which the Debenture Premium Account shall be dealt with, but it is considered that it cannot be regarded as a profit which is divisible through the Profit and Loss Account, and should therefore be classified as a capital reserve. It is frequently utilised to form the nucleus of a debenture redemption fund ; if not employed in this manner it could be applied in writing off fictitious assets. It is usual to charge the expenses of issue of the debentures against the premium received.

(d) Debentures issued at a discount

Debentures can be issued at a discount, and the discount can be regarded as a

lump sum allowed to the lenders at the time of their taking up the debentures, in consideration of a lower rate of interest being payable than would have been the case had the debentures been issued at par. The financial position of the company and the state of the money market at the date of issue are important factors in determining the price of issue.

The effect of issuing debentures at a discount can be seen from the following example:

Illustration (1)

A company issued debentures of £100 each at 95, interest at 5%, repayable at the end of 20 years at par.

Over the 20 years, therefore, ignoring income tax, the holder receives £100 as interest, and at the end of that period is repaid £100 in respect of each £95 advanced. The average return is therefore $\frac{£200-95}{20}$ = £5·25 on his investment of £95, or 5·5%. (This rate is not strictly accurate, as it ignores compound interest, but it is sufficiently accurate to show the effect.)

Where debentures are issued at a discount, cash is debited with the net sum received and Discount on Debentures Account with the amount of the discount, Debentures Account being credited with the full nominal value of the debentures, at which value they must appear as a liability in the balance sheet. The Discount on Debentures, or so much thereof as has not been written off, must be shown separately in the balance sheet (8th Schedule, Pt. 1).

The discount on the issue is, in effect, deferred interest, and should accordingly be written off over the period having the use of the money raised by the debentures, unless a sinking fund is created to accumulate the full redemption price, including the discount. Where the debentures are redeemable at the end of a specified period, the discount should be written off by equal annual instalments over that period. If, however, the debentures are to be redeemed by annual drawings, the discount should be written off by proportionately reducing instalments, since each succeeding year has the use of a reducing amount of principal.

Illustration (2)

A company issued on 1st January, 19..., thirty debentures of £100 each at 90, repayable by instalments of £1,000 at the end of the first, second, and third years respectively. Show the Discount Account, assuming the discount to be written off over the period proportionately.

DISCOUNT ON ISSUE OF DEBENTURES ACCOUNT

		£			£
1st year Jan 1	To Debenture Account	300	1st year Dec. 31	By Profit and Loss Account—three-sixths of £300.	150
				„ Balance c/d.	150
		£300			£300
2nd year Jan. 1	To Balance b/d.	150	2nd year Dec. 31	By Profit and Loss Account—two-sixths of £300	100
				„ Balance c/d.	50
		£150			£150
3rd year Jan 1	To Balance b/d.	50	3rd year Dec. 31	By Profit and Loss Account—one-sixth of £300	50
		£50			£50

Note

In the above illustration the discount has been written off against the profits of the respective years in the proportions of 3: 2: 1, since the first year has the use of £3,000, the second year £2,000 and the third year £1,000 of the capital provided by the debentures.

Where the redemption of the nominal amount of the debentures repayable is provided for by charges against Profit and Loss Account, such charges should include the provision for discount, in which case the discount can be written off against the credit balance on the redemption account.

(e) Debentures repayable at a premium

These debentures will stand in the balance sheet as a liability at their nominal amount, with a note of the amount at which they are repayable, any discount or premium on issue being treated as described above.

If a sinking fund is raised to provide for repayment, it should include provision for the payment of the premium on redemption. If no sinking fund is created, the premium should be provided for out of profits over the period of the debentures, in a similar manner to that in which discount is written off.

Debentures may even be issued at a discount and repayable at a premium.

Illustration

A company issued 100 debentures of £100 each, at a discount of 5%, repayable at 102 at the end of 10 years.

Over the 10 years, in addition to the interest payable, there must be charged against Profit and Loss Account £7 per £100 debenture, *i.e.*, £700 in all, by yearly amounts of £70. Of this £50 is credited to Discount on Debentures Account, and £20 to a Provision for Premium on the Redemption of Debentures Account.

If the debentures were repayable by equal annual drawings, the £700 would be charged in the ratio of 10, 9, 8, 7, 6, 5, 4, 3, 2, 1, *i.e.* $\frac{10}{55}$ths of £700 = £127 5s. 5d. would be charged to Profit and Loss Account in the first year, $\frac{9}{55}$ths of £700 £114 10s. 11d. in the second year, and so on. The premium paid on redemption would be debited to the Reserve Account, and the balance carried forward until the last year, when it would be closed by the last redemption.

(f) Redemption of Debentures

Debentures may be irredeemable (*i.e.*, the company may be under no obligation to repay the debentures at any specified date), but this is unusual in the case of a limited company. It is more usual to find irredeemable debentures or debenture stock in the case of companies formed under special Act of Parliament.

Debentures may either be redeemable at the end of a given period or by annual drawings. The trust deed, or if there is no deed, then the debentures themselves, will contain provision for redemption, and will also usually stipulate for a sinking fund to be established out of the profits for the purpose of repayment. An illustration of the entries in the company's books in a case of this nature is given below.

Another method is for the company to take out a sinking fund policy with an insurance company for the amount of the debentures.

Under Section 90, where a company has redeemed any debentures, it has power to re-issue them, either by re-issuing the same debentures, or by issuing other debentures

in their place, unless provision, express or implied, is contained in the articles or the conditions of issue, or unless the company has, by passing a resolution, or by some other act, manifested its intention that the debentures shall be cancelled. Where a company has redeemed any debentures, particulars with respect to those which can be re-issued must be included in every balance sheet of the company. On re-issue, the debentures must be stamped as if they were an original issue. They have this advantage, however, that they will rank *pari passu* with the outstanding debentures of the same series, *i.e.*, the re-issued debentures will have the same priorities as the original debentures.

In some instances, a company purchases its own debentures, as and when convenient, in the open market, subsequently cancelling the liability *pro tanto*. This procedure would be adopted when the debentures were quoted at a discount, so that a profit would result from the transaction. This profit is of a capital nature and should not be utilised for purposes of distribution as dividend.

Illustration (1)

A company issued £100,000 4% debenture stock at 98 on the 1st January, 1955, the interest being payable half-yearly on 30th June and 31st December. The stock is to be redeemed at the end of 20 years, at 102½, but the company has power to redeem on any earlier date after the first year at 105, upon giving 6 months written notice of its intention. Provision is made for the establishment of a sinking fund, and the annual contribution of £2,000, together with the interest received during the preceding year, is to be invested on the 1st January in each year, the first investment being made at the beginning of the second year. The trustees are empowered to purchase debentures in the open market should they be below par, and to realise the sinking fund investments for this purpose. Investments were realised as follows, in order to purchase debenture stock:—

	Original Cost	Produced	Nominal value of Debenture Stock Purchased
30th April, 1956	£1,050	£1,060	£1,100
30th September, 1957 ...	2,000	2,100	2,150

The amounts of interest received on the sinking fund investments for 1956, 1957 and 1958 were £40, £80 and £120, respectively.

Prepare accounts showing the transactions up to 31st December, 1958. Ignore income tax and calculate to the nearest £.

DEBENTURE STOCK ACCOUNT

		£			£
1956 Dec. 31	To Debenture Redemption Account, cancellation of £1,100 Debenture Stock	1,100	1955 Jan. 1	By Sundries	100,000
	„ Balance c/d.	98,900			
		£100,000			£100,000
1957 Dec. 31	To Debenture Redemption Account, Cancellation of £2,150 Debenture Stock	2,150	1956 Jan. 1	By Balance b/d	98,900
	„ Balance c/d.	96,750			
		£98,900			£98,900
			1957 Jan.	By Balance b/d	96,750

DISCOUNT ON DEBENTURES ACCOUNT

		£			£
1955 Jan. 1	To Sundries	2,000	1956 Dec. 31	By General Reserve Account ...	1,100
				„ Balance c/d.	900
		£2,000			£2,000
1956 Jan. 1	To Balance b/d.	900	1957 Dec. 31	By General Reserve Account ..	900

SINKING FUND ACCOUNT

		£			£
1956 Dec. 31	To General Reserve Account ..	1,100	1955 Dec. 31	By Profit and Loss Account ..	2,000
	„ Balance c/d ..	3,005	1956 Dec. 31	„ Sinking Fund Investments Account—Profit on sale .	
				„ Debenture Redemption Account—Profit on purchase	
				„ Interest on Investments .	40
				„ Profit and Loss Account	2,000
		£4,105			£4,105
1957 Dec. 31	To General Reserve Account .	2,150	1957 Jan. 1	By Balance b/d.	3,005
	„ Balance c/d .. .	3,106	Dec. 31	„ Sinking Fund Investments Account—Profit on sale ..	100
				„ Debenture Redemption Account—Profit on purchase ...	71
				„ Interest on Investments	80
				„ Profit and Loss Account	2,000
		£5,256			£5,256
1958 Dec. 31	To Balance c/d. . .	5,226	1958 Jan. 1	By Balance b/d.	3,106
			Dec. 31	„ Interest on Investments	120
				„ Profit and Loss Account	2,000
		£5,226			£5,226
			1959 Jan. 1	By Balance b/d.	5,226

SINKING FUND INVESTMENTS ACCOUNT

		£			£
1956 Jan. 1	To Cash	2,000	1956 Apr. 30	By Cash	1,060
Dec. 31	„ Sinking Fund Account—Profit on sale of investments .	10		„ Balance c/d.	950
		£2,010			£2,010
1957 Jan. 1	To Balance b/d.	950	1957 Sept. 30	By Cash	2,100
	„ Cash	2,055	Dec. 31	„ Balance c/d.	1,005
Dec. 31	„ Sinking Fund Account—Profit on sale of investments ...	100			
		£3,105			£3,105
1958 Jan. 1	To Balance b/d. . ..	1,005	1958 Dec. 31	By Balance c/d.	3,106
	„ Cash	2,101			
		£3,106			£3,106
1959 Jan. 1	To Balance b/d. ...	3,106			

DEBENTURE REDEMPTION ACCOUNT

1956			1956		
Apr. 30	To Cash, Purchase of £1,100 Debentures *cum. div.*	1,060	Apr. 30	By Debenture Interest Account, 4 months accrued interest on £1,100 Debentures purchased *cum. div.*	15
Dec. 31	„ Sinking Fund Account—Profit on Debentures purchased for cancellation	55	Dec. 31	„ Debentures Account, Debentures cancelled	1,100
		£1,115			£1,115
1957			1957		
Sept. 30	To Cash, Purchase of £2,150 Debentures *cum. div.*	2,100	Sept. 30	By Debenture Interest Account, 3 months accrued interest on £2,150 Debentures purchased *cum. div.*	21
Dec. 31	„ Sinking Fund Account—Profit on Debentures purchased for cancellation	71	Dec. 31	„ Debentures Account, Debentures cancelled .	2,150
		£2,171			£2,171

DEBENTURE INTEREST ACCOUNT

		£			£
1955			1955		
June 30	To Cash— ½ yrs' Interest on £100,000 ..	2,000	Dec. 31	By Profit and Loss Account	4,000
Dec. 31	„ „ „ ..	2,000			
		£4,000			£4,000
1956			1956		
Apr. 30	To Debenture Redemption Account—Interest on £1,100 Debentures purchased *cum. div.*	15	Dec. 31	By Profit and Loss Account ..	3,971
June 30	„ Cash— ½ yrs.' Interest on £98,900 ..	1,978			
Dec. 31	„ „ ..	1,978			
		£3,971			£3,971
1957			1957		
June 30	To Cash — ½ yrs.' Interest on £98,900 ..	1,978	Dec. 31	By Profit and Loss Account .	3,934
Sept. 30	„ Debenture Redemption Account—Interest on £2,150 Debentures purchased *cum. div.*	21			
Dec. 31	„ Cash— ½ yrs.' Interest on £96,750	1,935			
		£3,934			£3,934
1958			1958		
June 30	To Cash— ½ yrs.' Interest on £96,750 ..	1,935	Dec. 31	By Profit and Loss Account	3,870
Dec. 31	„ „ „ ...	1,935			
		£3,870			£3,870

SINKING FUND CASH ACCOUNT

		£			£
1955			1956		
Dec. 31	To General Cash—Annual Instalment	2,000	Jan. 1	By Sinking Fund Investment Account	2,000
1956					
Apr. 30	„ Sinking Fund Investment Account, Proceeds of sale ...	1,060	Apr. 30	„ Debenture Redemption Account, Debentures purchased	1,060
Dec. 31	„ Interest on Investments ..	40	Dec. 31	„ Balance c/d.	2,055
	„ General Cash—Annual Instalment	2,000			
	„ General Cash—Refund of Interest on Debentures cancelled	15			
		£5,115			£5,115

SINKING FUND CASH ACCOUNT—*continued*

1957		£	1957		£
Jan. 1	To Balance b/d.	2,055	Jan. 1	By Sinking Fund Investment Account	2,055
Sept. 30	,, Sinking Fund Investment Account, Proceeds of Sale	2,100	Sept. 30	,, Debenture Redemption Account, Debentures purchased	2,100
Dec. 31	,, Interest on Investments	80	Dec. 31	,, Balance c/d.	2,101
	,, General Cash—Annual Instalment	2,000			
	,, General Cash—Refund of Interest on Debentures cancelled	21			
		£6,256			£6,256
1958			1958		
Jan. 1	To Balance b/d.	2,101	Jan. 1	By Sinking Fund Investment Account	2,101
Dec. 31	,, Interest on Investments	120	Dec. 31	,, Balance c/d.	2,120
	,, General Cash—Annual Instalment	2,000			
		£4,221			£4,221
1959					
Jan. 1	To Balance b/d.	2,120			

GENERAL RESERVE ACCOUNT

1956			1956		£
Dec. 31	To Discount on Debentures Account	1,100	Dec. 31	By Sinking Fund Account	1,100
1957			1957		
Dec. 31	To Discount on Debentures Account	900	Dec 31	By Sinking Fund Account	
	,, Balance c/d	1,250			
		£2,150			£2,150
			1958		
			Jan. 1	By Balance b/d	1,250

Notes

(1) The accrued interest included in the *cum. div.* price of the debentures purchased must be debited to Debenture Interest Account, and only the balance of the price treated as the cost of the debentures cancelled, in arriving at the profit or loss on cancellation. The amount of such accrued interest, having been paid out of sinking fund cash, must be reimbursed thereto out of general cash, and reinvested.

(2) No purpose is served by apportioning the proceeds of sale of the investments between capital and income, as both the interest earned and any profit or loss on realisation of the investments must be transferred to the Sinking Fund Account.

(3) An amount equal to the nominal amount of the debenture stock cancelled has been transferred from the Sinking Fund Account to General Reserve, as the assets representing it are now part of the general assets and are not included in the Sinking Fund Investment Account.

(4) The discount allowed on the issue of the cancelled debenture stock must be written off, since the debentures are no longer outstanding. As, however, the general reserve is available, it has been thought advisable to write off the whole discount against it immediately.

Another method of dealing with debentures purchased in the open market is to keep them alive, and treat them as investments of the sinking fund. The annual appropriation of profits is credited to Sinking Fund Account, and the amount expended in the purchase of debentures debited to Sinking Fund Investment Account. Interest on such debentures is credited to the Sinking Fund Account and invested as if it were from an 'outside' investment of the fund.

The sinking fund instalments are originally computed on the basis that they will accumulate at compound interest over the term of the debentures. Where, therefore, investments are realised and debentures purchased at an earlier date, the sinking fund is deprived of interest, and its basis vitiated. On each purchase of debentures, this fact must be borne in mind, and, if necessary, the sinking fund compensated for the loss of interest. This can be done by—

(*a*) recomputing the annual instalments, having regard to the nucleus available and the remainder of the term of the debentures; or

(*b*) computing the interest on the debentures purchased, and adding this amount to the annual instalment to be set aside and invested; or

(*c*) charging as an addition to the annual instalment the interest lost to the sinking fund by the sale of investments.

Methods (*b*) and (*c*) have no exactitude; they are mere expedients. Method (*b*) involves an increasing annual appropriation of profits; method (*c*) may fail to provide adequate funds. Accordingly, method (*a*) is strongly advised.

Where no sinking fund is provided, an amount equal to the cash applied in purchasing or redeeming debentures should be transferred from Profit and Loss Account to reserve (unless the necessary funds are already in that account) in order to preserve working capital, the cash utilised being accumulated profits withheld from distribution. This automatically adjusts for any premium or discount.

Illustration (2)

On 1st January, 19... a company had outstanding £50,000 5% debentures. On the following 31st December, the company purchased for cancellation £20,000 debentures at 98, the expenses being £100. The profits for the year amounted to £34,000.

Show journal entries recording the above transactions, including the cash transactions.

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		£	£
5% Debentures Account	*Dr.*	20,000	
To Debenture Redemption Account	...		20,000
Transfer of £20,000 Debentures for cancellation as per Minute dated .			
Debenture Redemption Account	*Dr.*	20,000	
To Cash			19,700
Reserve			300
Purchase and cancellation of £20,000 Debentures at 98, Expenses £100, and transfer of profit.			
Profit and Loss Account	*Dr.*	19,700	
To Reserve			19,700
Transfer of amount equal to cost of Debentures purchased.			

Note

As the company's liquid resources have been reduced by £19,700, it is desirable to transfer an equivalent amount to reserve from Profit and Loss Account, so that the balance of the latter account will not overstate the amount which is available for distribution. This entry reflects that the purchase of the debentures has been effected out of profits, and to the extent that profits have been used for this purpose they cannot be distributed as dividend, without seriously depleting the company's working capital.

Debentures may be redeemable by annual drawings, in which case an amount equal to the cash applied each year in the redemption should be transferred to reserve (unless already therein) for the reasons already stated, any premium

or discount being debited or credited to reserve as in the case of the purchase of debentures in the open market.

If there is no sinking fund, it is unusual for a company to acquire its own debentures as an investment, although on occasion, it may be economical to do so, *e.g.*, where the rate of interest payable is more than can be earned on other investments, and the market price of the debentures is favourable, or the terms of the debentures forbid cancellation at the time. In such a case, it is desirable to debit the interest on the debentures so purchased to the Debenture Interest Account and credit Profit and Loss Account as a separate item, so that the exact position is disclosed.

Illustration (3)

Wyezed Ltd. had outstanding £60,000 5% debentures at the beginning of the year 19. , interest payable 31st March and 30th September. During the year, debentures were purchased in the open market as follows:—

15th March, £10,000 nominal, *ex* interest, cost £9,890.
1st August, £8,000 ,, *cum* ,, ,, £8,050.

The debentures were retained as an investment. Write up the Investment Account, Debenture Account, and Debenture Interest Account for the year to 31st December. Apportion in months and ignore income tax.

The debentures were cancelled on the following 31st March. Write up the accounts to that date, making calculations to the nearest £. Ignore income tax.

DEBENTURE ACCOUNT

		£			£
Mar. 31	To Own Debenture Investment Account- cancellation of debentures purchased . ..	18,000	Jan. 1	By Balance b/f	60,000
	,, Balance c/f. .	42,000			
		£60,000			£60,000

OWN DEBENTURES INVESTMENT ACCOUNT

		Nominal.	Interest.	Principal.			Nominal.	Interest.	Principal.
		£	£	£			£	£	£
Mar. 15	To Cash - purchase *ex.* interest	10,000		9,890	Mar. 15	By Principal—contra		21	
	,, Interest—contra, ½ month to 31st March . .			21	Sept. 30	,, Debenture Interest Account, ½ year's interest .		450	
Aug. 1	,, Cash—purchase *cum* interest . . . Cost . £8,050 *Less* accrued interest 4 months. . 133	8,000	133	7,917	Dec. 31	,, Balance, interest accrued, c/d. ..		225	
						,, Balance c/d .	18,000		17,828
Dec. 31	,, Profit and Loss Account . ..		563						
		£18,000	£696	£17,828			£18,000	£696	£17,828
19. .					19.				
Jan. 1	To Balances b/d.	18,000	225	17,828	Mar. 31	By Debenture Interest Account . ..		450	
Mar. 31	,, Reserve—Profit on cancellation ...			172		,, Debentures Account cancellation .	18,000		18,000
	,, Profit and Loss Account		225						
		£18,000	£450	£18,000			£18,000	£450	£18,000

DEBENTURE INTEREST ACCOUNT

		£			£
Mar. 31	To Cash	1,500	Jan. 1	By Balance, accrued interest b/f.	750
Sept 30	„ Own Debenture Investment Account	450	Dec. 31	„ Profit and Loss Account	3,000
	„ Cash	1,050			
Dec. 31	„ Balance, accrued interest c/d.. .	750			
		£3,750			£3,750
Mar 31	To Own Debenture Investment Account	450	Jan. 1	By Balance b/d.	750
	„ Cash ...	1,050	Mar. 31	„ Profit and Loss Account	750
		£1,500			£1,500

RESERVE ACCOUNT

		£
Mar. 31	By Own Debenture Investment Account	172
	„ Profit and Loss Account	17,828
		18,000

Notes

(1) The interest credited to Profit and Loss Account at 31st December, 19... is made up as follows:

$9\frac{1}{2}$ months at 5% on £10,000 =	£395	16	8	
5 „ „ „ „ £8,000 =	166	13	4	
	£562	10	0	(say £563)

(2) Whilst it is prudent to keep the profit on redemption of debentures in reserve, owing to its being a capital profit, there is nothing to prevent its being credited to revenue if it is in fact intact on a revaluation of the assets and liabilities. In order to maintain working capital, a transfer has been made from Profit and Loss Account of the amount required to increase the reserve to a sum equal to the nominal value of the debentures redeemed.

(g) Debentures issued as security for a loan

It is a common practice for companies to issue their own debentures as security against a loan or overdraft from a bank or other parties. Section 90 (4), expressly refers to this procedure, and provides that such debentures shall not be deemed to have been redeemed by reason only of the account of the company having ceased to be in debit whilst the debentures remained so deposited.

The term 'collateral' is commonly applied to such a security, since the amount of
17 82 the debentures will not appear in the company's accounts as a liability in addition to the loan or overdraft; but this description is not strictly correct, since the debentures are in fact issued by the company itself and not by a third party, as the expression would seem to imply. The term 'additional security' appears to be a more accurate one to employ.

When debentures are issued in this manner, they should be shown 'in short' in the balance sheet, and stated as having been issued as security. The loan against which they are issued will be extended as a liability in the usual way. A note of the issue should be made at the head of the Debenture Account in the ledger. The debentures require registration in the ordinary way.

The transaction is sometimes recorded by crediting the Debenture Account with the amount of these debentures, and debiting a Debenture Suspense Account with the same amount, the latter item appearing on the assets side of the balance sheet. When the debentures are released, the entry is written back, and consequently disappears from both sides of the balance sheet. There does not appear to be any particular advantage in adopting this method, as the whole of the facts are clearly disclosed in the balance sheet by the first method of treatment described above; moreover, the introduction to the assets side of the balance sheet of unnecessary suspense accounts is apt to cause confusion.

No interest is payable on such debentures; the interest on the bank loan or overdraft is paid in the usual way, and the bank will only resort to the debentures in the event of this becoming necessary to protect their security, *e.g.*, where liquidation ensues or a receiver is appointed.

(h) Debenture interest in the final accounts

Interest on debentures is a definite liability which is payable whether or not the profits earned are sufficient to provide for it. When preparing the final accounts for an accounting period, therefore, provision must be made for any interest accrued to the date of the balance sheet, so that the Profit and Loss Account will be charged with interest for the whole period, and any accrued liability not yet paid will appear in the balance sheet. Although interest on debentures, being 'annual interest' for income tax purposes, must be paid less tax, the tax deducted has to be accounted for, either as part of the assessments on the company's income or (where the interest exceeds the total income) under a separate assessment, and the true measure of the charge is thus the gross interest. The correct practice is therefore to debit the gross amount of the interest to Profit and Loss Account, crediting the income tax recouped by deduction to Income Tax Account. This practice has the approval of the Council of the Institute of Chartered Accountants in England and Wales, and appears to be sanctioned by the provision in the 8th Schedule, Pt. I, which requires the amount of the interest to be shewn in the Profit and Loss Account.

(i) Conversion of debentures into new debentures carrying a lower rate of interest

In some circumstances the low rates of interest prevailing make it necessary for companies to review their position regarding debentures. Where the debentures permit the company to redeem on 6 months' notice, the company is able to give the necessary notice and at the same time offer new debentures carrying a lower rate of interest in exchange. Where the holders of the old debentures do not take up the new debentures in full, the balance is offered to the public for subscription or placed privately. In such a case, the entries are simple, *viz.*, Old Debentures Account is debited and New Debentures Account credited with the debentures exchanged, in so far as the holders accept; Old Debentures Account is debited, and cash credited in respect of the old holders who desire to be paid out; the usual entries for the issue of debentures in respect of those issued to the public or private subscribers.

In some cases, however, there is no power of redemption at the date when the company desires to reorganise its position, and it is necessary to come to an arrangement with the debenture holders whereby some consideration is given for their agreeing to accept a lower rate of interest in future, *e.g.*, a cash payment, or an issue of new debentures repayable at a premium. The relevant entries are shown in the following illustration which embodies a cash payment and an issue of new debentures repayable at a premium.

Illustration

A company came to an arrangement with its debenture holders, who held £100,000 5½% debentures, whereby the debentures were to be repaid at 103, the holders having the option to convert into 4½% debentures repayable by annual drawings over 20 years at 104. Holders of £60,000 5½% debentures exercised the option, and the company invited applications from the public for the remaining £40,000 4½% £100 debentures at 101, payable as follows: On application £20; on allotment £31, and at intervals of one month thereafter, £25 per instalment. Applications from the public for £90,000 debentures were received. Allotment was made in full to existing holders who, in addition to converting their own holdings, applied for £25,000 4½% debentures; no allotments were made to other applicants for less than £500 stock (amounting to £20,000 nominal); *pro rata* allotments were made to other applicants.

Show the journal entries recording the above transactions. Journalise the cash transactions.

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			£	£
5½% Debentures Account	*Dr.*		100,000	
To 4½% Debentures Account				60,000
Sundry Debenture Holders				40,000
Conversion by holders of £60,000 5½% debentures into 4½% debentures, and transfer of balance for repayment.				
Profit and Loss Account	*Dr.*			
To Sundry Debenture Holders				1,200
Premium on repayment of £40,000 5½% debentures.				
Cash			18,000	
To 4½% Debentures Application and Allotment Account				
£20 per debenture on £90,000 Debentures applied for				
4½% Debentures Application and Allotment Account	*Dr.*		24,400	
To 4½% Debentures Account				20,000
Premium on Issue of Debentures Account				400
Cash				4,000
Allotment per minute of this day of £25,000 debentures to existing holders in full; £15,000 debentures to applicants for £45,000, *pro rata*, £51 being due on application and allotment on each £100 debenture and refund of application money on application for £20,000 debentures.				
Cash	*Dr.*		7,750	
To 4½% Debentures Application and Allotment Account				7,750
Allotment moneys received on £25,000 debentures allotted in full, £31 per £100 debenture.				
4½% Debentures Application and Allotment Account	*Dr.*		1,350	
To 4½% Debentures First Instalment Account				1,350
Transfer of amounts overpaid on application towards amount payable on instalments on £15,000 allotted *pro rata* to applicants for £45,000 debentures, made up as follows:				
£31 per £100 on £15,000 Debentures now due		£4,650		
£20 „ „ „ £30,000 „ not allotted		6,000		
Excess carried forward		£1,350		
4½% Debentures First Instalment Account	*Dr.*		10,000	
To 4½% Debentures Account				
£25 per £100 debenture due on £40,000 Debentures.				
Cash	*Dr.*		8,650	
To 4½% Debentures First Instalment Account				8,650
Balance due now received.				

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		£	£
4½ % Debentures Second Instalment Account ...	Dr.	10,000	
To 4½ % Debentures Account			10,000
Final instalment of £25 per debenture now due.			
Cash	Dr.	10,000	
To 4½ % Debentures Second Instalment Account			10,000
Balance due now received			
Sundry Debenture Holders . ..	Dr.	41,200	
To Cash			41,200
Redemption of £40,000 debentures at 103.			

NOTE.—The premium on the new issue could be applied towards writing off the premium payable on the debentures redeemed the balance of the premium being written off to Profit and Loss Account.

§ 11. The purchase of a Business by a Limited Company

As already explained in § 1 of this chapter, many advantages may stem from the 'conversion' of a private business into a limited company, one of the most important being the attribute of perpetual succession, which enables a member of a company to transfer his shares therein, or to transmit them by will on his death, without the constitution of the company or its financial resources being disturbed.

The so-called 'conversion' may take the form of the transfer to a private company of the assets and goodwill of the business in consideration of the allotment of shares in the company, which the vendors of the business will continue to hold, and by means of which they will retain the control of the business. Alternatively, a public company may be formed for the purpose of acquiring the business, a common procedure being for a promoter or syndicate to purchase the business from the original owners, and then resell it to the company at a profit, the capital of the company being raised by public subscription. Or again, a public company may be formed to take over the business of a private company, the shareholders of the latter receiving shares or other interests in the public company in exchange for their existing holdings.

In either case, the transactions to be recorded, from the new company's point of view, are the same, as will be seen hereunder. It by no means follows, however, that the assets acquired by the company will be taken into its books at the same valuations as those at which they stood in the books of the firm. Where a public issue of capital is made, a revaluation of all the fixed assets is usually undertaken, and frequently the vendors guarantee the payment of the book debts. In many cases the company assumes the trade liabilities as part of the purchase consideration. In others the company discharges the liabilities and collects the book debts as agents for the vendors, interest being charged or allowed, as the case may be, until a final settlement between the company and the vendors is effected.

When the book debts are taken over by the company, they are usually acquired at their book values less an agreed percentage for bad and doubtful debts. Should the book debts realise more than the net amount at which they are taken over, the excess is strictly of the nature of a capital profit to the company.

In addition to the purchase price of the tangible assets, a further sum is usually payable in respect of goodwill. A company making a public issue for the purpose of acquiring a business must state in the prospectus the amount of the purchase consideration attributable to goodwill. From the book-keeping point of view the

goodwill will be represented by the excess of the total amount of the purchase consideration over the value of the other assets acquired, less the amount of any liabilities assumed by the company.

(a) Entries in the purchasing company's books

The entries in the company's books necessary to record the purchase of the business are as follows:

1. Debit the respective asset accounts with the assets acquired, and credit the liability accounts with the amounts of any liabilities taken over by the company, crediting the Vendor's Account with the amount of the purchase consideration. If the total assets exceed the liabilities taken over plus the consideration, the balance is in the nature of a capital profit and should be credited to a Capital Reserve Account. If the liabilities plus the consideration exceed the amount of the total assets, the resulting debit balance is the price paid for goodwill and must be debited to Goodwill Account.

2. Debit the Vendor's Account and credit Share Capital Account, Debentures Account, Cash, etc., with the shares, debentures, cash, etc., issued or paid by the company in discharge of the purchase consideration.

Some accountants prefer to pass the transactions relating to the purchase of the business through an account called 'Purchase of Business Account', which takes the place of the Vendor's Account, being credited with the assets acquired and debited with the liabilities taken over and with the purchase consideration.

Illustration (1)

A company takes over the following assets and liabilities of a private business:

Leasehold Property	£7,000
Plant and Machinery	3,000
Stock-in-Trade	4,600
Sundry Debtors	3,000
	1,500
	19,100
Less Trade Creditors	2,100
	£17,000

The purchase consideration is £20,000, and is payable to the vendor as follows: £10,000 in ordinary shares of £1 each fully paid, £5,000 in 5 per cent. preference shares of £1 each fully paid, all issued at par, and the balance in cash. Show the opening journal entries in the books of the company.

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Sundries,			
To Sundries—			
Leasehold Property		7,000	
Plant and Machinery		3,000	
Stock-in-Trade		4,600	
Sundry Debtors ...		3,000	
Cash		1,500	
Goodwill ...		3,000	
Sundry Creditors			2,100
Vendor (or Purchase of Business Account)			20,000
Being sundry assets and liabilities taken over as per contract dated ..			
		£22,100	£22,100
		£	
Vendor (or Purchase of Business Account) ...	*Dr.*	20,000	
To Sundries—			
Ordinary Share Capital—10,000 Shares of £1 each fully paid			10,000
Preference Share Capital—5,000 Shares of £1 each fully paid			5,000
Cash ...			5,000
Being discharge of purchase consideration as per contract dated...			
		£20,000	£20,000

Note

The amount debited to Goodwill Account is the excess of the amount of the purchase consideration, £20,000, over the total amount of the assets acquired, less the amount of the liabilities assumed, £17,000.

Where the purchase consideration is less than the value at which the net assets stood in the books of the vendor, but the values of the assets taken over are correctly stated (as ascertained by revaluation), the surplus, instead of being treated in the company's books as a capital reserve, may be applied in writing down fixed assets to the level of the consideration. In no case should such surplus be distributed as a profit or credited to such an account as general reserve, which is a revenue reserve and may only be credited with amounts which are available for distribution.

No account for goodwill should be raised in the company's books unless goodwill is actually paid for, even though valuable goodwill may, in fact, be acquired. The absence of a Goodwill Account would merely indicate that no expenditure of capital has been incurred in acquiring this asset.

Where a partnership business is transferred to a limited company some difficulty may be experienced in capitalising the company in such a way that the rights of the partners as shareholders will be similar to those they enjoyed in the firm. If the capitals of the partners are in the same ratio as that in which profits are shared, the problem is simplified, as the allotment of ordinary shares in that ratio will preserve the relationship as nearly as possible. In the many cases, however, where the capitals are not held in profit-sharing ratio, the problem is more complicated, particularly when the income tax position is borne in mind.

The following example shows a typical problem of the latter description, with a suggestion for its solution.

Illustration (2)

A, B and C carried on business in partnership. On 31st March their Balance Sheet was as follows:

	£				£
Capital Accounts—			Goodwill		50,000
A	49,000		Freehold Premises at cost		22,000
B	21,000		Plant and Machinery at cost, less depreciation		9,000
C	10,000		Furniture, etc., at cost less depreciation		500
		80,000			
5% Loan A		10,000	Stock in Trade		17,000
			Sundry Debtors	£8,000	
Current Accounts—			*Less* Bad Debt Provision	400	
A	1,400				7,600
B	700		Payments in Advance		50
		2,100	Cash in Hand		3,420
Sundry Creditors		17,820	Current Account—C		350
		£ 109,920			£ 109,920

It was decided to form a limited company to take over the business as from 1st November. You are consulted by A, B and C as to the terms of the transfer and the rights of the partners in the company, having regard to the following information:

(*a*) The partners are entitled to interest at 6 per cent. per annum on their Capital Accounts, but no interest is charged or allowed on Current Accounts or on additions to capital.

(*b*) C is entitled to a salary of £1,000 per annum.

(*c*) Profits are shared in the ratio 5 : 3 : 2.

(*d*) It is desired to retain their respective rights in capital and profits as nearly as possible.

(e) A's loan is not to be repaid, but his rights in respect thereof are to remain similar to those he now enjoys, as nearly as may be practicable, having regard to the fact that he is to be allotted shares therefor.

(f) Current Accounts are to be cleared by cash payments.

(g) The assets, other than goodwill, are taken over at book values. Goodwill is revalued at £30,000.

(h) The partners wish to have the benefit of the maximum earned income allowance for income tax purposes.

Draft proposals for carrying the scheme into effect, and show the initial balance sheet of the company after giving effect thereto, taking the preliminary expenses at £1,200.

SUGGESTED SCHEME

1. The capitals of the partners in the business are not in proportion to their shares in profits and losses, with the result that if there were a heavy loss on realisation of the assets, some cash adjustment might be necessary between the partners. In order to retain a similar position in the proposed company, the adjustments mentioned in paragraph 3 hereunder are recommended.

2. The Capital Accounts, after writing down the goodwill, will be as follows :—

	A	B	C	Total
	£	£	£	£
Existing Capitals	49,000	21,000	10,000	80,000
Deduct Reduction in value of Goodwill in profit-sharing ratio (5 : 3 : 2)	10,000	6,000	4,000	20,000
Adjusted Capitals	£39,000	£15,000	£6,000	£60,000

3 If the capitals were in profit-sharing ratio, and C's capital was in the same proportion to the total capital as his share of profit, *viz.*, one-fifth, the total capital would be £30,000, and the relative excess capitals would be as follows:

	A	B	C
	£	£	£
Capitals as above	39,000	15,000	6,000
Less Capitals in the profit-sharing ratio	15,000	9,000	6,000
Surplus capital held by A and B over C	24,000	6,000	
As between A and B profits are divided in the proportion of 5 : 3. Assuming B's surplus to represent three-eighths of the total capital, A's proportionate surplus would be £10,000 ...	10,000	6,000	
A's absolute surplus capital over that of B andC is therefore ...	£14,000		

In the event of a winding-up, therefore, A should receive out of the realisation of the assets £14,000 before B and C are repaid anything. The next £16,000 should be shared by A and B in the ratio of 5 : 3, and the balance by A, B and C in their profit-sharing ratio.

4. To achieve the desired result, the scheme must embody the following principles:

(*a*) In order that the ultimate net profit shall continue to be shared in the proportions of 5 : 3 : 2, ordinary shares must be issued to the partners in those proportions in respect of that part of their capital which is in their profit-sharing ratio; i.e., £15,000, £9,000 and £6,000 respectively.

(*b*) To equate the rights of the partners as to interest on capital, two classes of preference shares must be issued for the balance of the respective capitals: 'A' shares to A for his £14,000 absolute surplus, and 'B' shares (ranking after the 'A' shares) to A and B for £10,000 and £6,000 respectively. If deemed desirable, these shares may carry a fixed rate of dividend of 6%, but it is suggested that they carry no interest, this being adjusted for as explained hereunder.

(*c*) 10,000 5% cumulative redeemable preference shares of £1 each to be issued to A in respect of his loan, such shares to have priority over all other classes of shares as to dividend and as to repayment of capital in the event of liquidation. The shares should be redeemable, in case the company should at any time find itself in a position to dispense with the capital represented thereby.

(*d*) None of the above preference shares are to be entitled to share in any surplus of assets remaining after the repayment of the nominal value of all share capital on a winding-up, but all arrears of preference dividend due on such shares to be paid off before repaying capital.

(*e*) The ordinary shares to rank for dividend and repayment of capital after the preference shares, and to carry the right to any surplus of assets on a winding-up.

(*f*) C to receive a salary of £1,000 per annum.

(*g*) Directors' emoluments, *payable out of the profits remaining after providing for the 5% preference dividend and C's salary*, to be paid to A, B, and C, of an amount sufficient to enable each partner to obtain the maximum earned income allowance where the profits are sufficient for that purpose. In respect of the former interest on excess capital, A must receive fees of £1,440, and B £360, being 6% on their respective excesses over the capital of C. The balance could be voted as salaries each year by way of a percentage of the profits available, the total amount so voted being divided between A, B and C in the proportions of 50 per cent., 30 per cent., and 20 per cent. respectively.

Alternatively, the articles may provide that the directors shall receive as salaries the whole of the profits remaining after the payment of the 5% preference dividend and C's salary, such salaries to be divided among them as they shall agree. The directors can then enter into an agreement amongst themselves to divide such amount as they would have divided the profits if the partnership had continued.

5. The distribution of profits in the partnership and the company respectively is illustrated by the following statements:

Profits assumed £10,000.

PARTNERSHIP.	A.	B.	C.
	£	£	£
Loan Interest ..	500		
Interest on Capital—			
6% on £39,000	2,340		
6% on £15,000		900	
6% on £6,000			360
Salary, C.			1,000
Balance 5 : 3 : 2 ..	2,450	1,470	980
	£5,290	£2,370	£2,340

COMPANY.	A.	B.	
	£	£	£
5% Preference Shares Dividend	500		
Salary			1,000
Director's Fees	1,440	360	—
Balance as Salaries in proportions of 5 : 3 : 2	3,350	2,010	1,340
	£5,290	£2,370	£2,340

It will thus be seen that the division of profits is identical in both cases, whilst the priorities as to repayment of capital are preserved, and the maximum available earned income allowance is obtained for all partners.

A, B & C LTD.
BALANCE SHEET AS AT 1ST APRIL

Share Capital—			Fixed Assets—			
Authorised, Issued and Fully Paid—			Goodwill at cost ...		30,000	
10,000 5% Cumulative Redeemable Preference Shares of £1 each ...	10,000		Freehold Premises at cost ...		22,000	
14,000 'A' Preference Shares of £1 each	14,000		Plant and Machinery at cost		9,000	
16,000 'B' Preference Shares of £1 each	16,000		Furniture, etc., at cost ...		500	
30,000 Ordinary Shares of £1 each	30,000					61,500
		70,000	Current Assets—			
Sundry Creditors ...		17,820	Stock-in-Trade...		17,000	
			Sundry Debtors	8,000		
			Less Bad Debt Provision ...	400		
					7,600	
			Payments in Advance		50	
			Cash in Hand		470	
						25,120
			Preliminary Expenses			1,200
		£87,820				£87,820

Note

Owing to the limitation of liability, it is impossible to provide entirely for the position which might arise in the event of the company proving unsuccessful, *e.g.*, in a partnership a partner's capital account may become in debit on dissolution, and he would have to introduce cash, whereas in a company a member cannot be called upon to contribute more than the amount (if any) unpaid on his shares.

The following illustration shows the effect on the books of the firm of the conversion of a private firm into a limited company, and also the entries in the books of the company:

Illustration (3)

The X Company, Limited, was formed to purchase the business of A and B, who share profits, two-thirds and one-third respectively, and whose balance sheet was as follows:

BALANCE SHEET
A AND B

		£			£
Creditors ..		2,700	Goodwill		1,000
Bills Payable		900	Freehold Property		5,000
Loan Account		400	Plant and Machinery		2,500
Capitals—			Stock		3,000
A	£8,000		Debtors .	£3,100	
B	5,000		*Less* Provision for Bad Debts	200	
		13,000			2,900
			Bills Receivable		800
			Investments		600
			Cash ...		1,200
		£17,000			£17,000

The company takes over the assets at book value, with the exception of the freehold property, which is taken over at £6,000. The investments are retained by the firm, and sold by them for £450. They also discharge the loan of £400, but the company takes over the remaining liabilities.

The purchase consideration for the net assets taken over is fixed at £18,950, payable as follows: £9,500 5 per cent. debentures, 7,600 fully paid ordinary shares of £1 each, both at par, and the balance in cash. A and B agree to divide the assets forming the purchase consideration in proportion to the balances standing to the credit of their respective capital

accounts, after the adjustments rendered necessary by the sale of the business and investments have been completed.

Show the ledger accounts closing the firm's books, and the journal entries opening the company's books.

FIRM'S BOOKS

REALISATION ACCOUNT

	£		£
To Freehold Property	5,000	By Creditors	2,700
„ Plant and Machinery	2,500	„ Bills Payable	900
„ Goodwill	1,000	„ Provision for Bad Debts	200
„ Stock	3,000	„ X Co. Ltd.	18,950
„ Debtors	3,100		
„ Bills Receivable	800		
„ Cash	1,200		
„ Loss on Investments	150		
„ Balance, being profit on realisation c/d.	6,000		
	£22,750		£22,750
	£		£
To Capital Accounts :—		By Balance b/d.	6,000
A two-thirds	4,000		
B one-third	2,000		
	£6,000		£6,000

X COMPANY LTD.

	£		£
To Realisation Account	18,950	By Debentures	9,500
		„ Ordinary Shares	7,600
		„ Cash	1,850
	£18,950		£18,950

DEBENTURES IN X CO. LTD.

			£
To X Co. Ltd	9,500	By A Capital Account	6,000
		„ B „ „	3,500
	£9,500		£9,500

ORDINARY SHARES IN X CO. LTD.

	£		£
To X Co. Ltd	7,600	By A Capital Account	4,800
		„ B „ „	2,800
	£7,600		£7,600

A CAPITAL ACCOUNT

			£
To Balance c/d	12,000	By Balance b/f.	8,000
		„ Profit on Realisation	4,000
	£12,000		£12,000
	£		£
To Debentures in X Co. Ltd.—twelve-nineteenths of £9,500	6,000	By Balance b/d	12,000
„ Shares in X Co. Ltd.—twelve-nineteenths of £7,600	4,800		
„ Cash—twelve-nineteenths of £1,900	1,200		
	£12,000		£12,000

B CAPITAL ACCOUNT

	£		£
To Balance c/d.	7,000	By Balance b/f.	5,000
		„ Profit on Realisation	2,000
	£7,000		£7,000
			£
To Debentures in X Co. Ltd.—seven-nineteenths of £9,500	3,500	By Balance b/d	7,000
Shares in X Co. Ltd.—seven-nineteenths of £7,600	2,800		
Cash—seven-nineteenths of £1,900	700		
	£7,000		£7,000

CASH BOOK

	£		£
X Co. Ltd	1,850	By Loan Account	400
Investments	450	„ Balance c/d.	1,900
	£2,300		£2,300
	£		£
Balance b/d	1,900	By A Capital Account	1,200
		„ B „	700
	£1,900		£1,900

INVESTMENTS

	£		£
To Balance c/f.	600	By Cash	450
		„ Realisation Account—loss	150
	£600		£600

LOAN

	£		£
To Cash	400	By Balance b/f.	400

X COMPANY LTD.'S BOOKS
JOURNAL

	Dr.	Cr.
Sundries.		
To Sundries		
Freehold Property	6,000	
Plant and Machinery	2,500	
Stock	3,000	
Debtors	3,100	
Bills Receivable	800	
Cash	1,200	
Goodwill	6,150	
Creditors		2,700
Bills Payable		900
Provision for Bad Debts		200
Vendors (or Purchases of Busines Account)		18,950
	£22,750	£22,750
Being sundry assets and liabilities taken over as per contract dated		

Note

The amount debited to Goodwill Account is the difference between the total of the assets, less the liabilities taken over, and the purchase consideration payable to the vendors.

	Dr.	£	£
Vendors (or Purchase of Business Account) ...	Dr.	18,950	
To Sundries—			
Ordinary Share Capital ...			7,600
Debentures ...			9,500
Cash ...			1,850
		£18,950	£18,950

Being 7,600 ordinary shares of £1 each, and £9,500 5% debentures issued fully paid, and cash paid in settlement of purchase consideration as per contract dated ... ...

Sometimes a company acquiring a business does not take over the book debts and liabilities of the vendor, but collects the book debts and pays the liabilities out of the proceeds thereof, accounting to the vendor for the balance. In such a case the company should provide special columns in its cash book, into which receipts from debtors and payments to creditors made on behalf of the vendor are entered, and from which they are posted to the personal accounts of the vendor's debtors and creditors. These postings, however, form no part of the double entry from the point view of the company, since the accounts to which the amounts are posted are not in the company's ledgers. The double entry in the company's books in respect of these transactions is completed by posting periodically the *totals* of the receipts and payments made on behalf of the vendor to the credit and debit respectively of the Vendor's Account. If the company wishes to continue to use the old debtors' and creditors' accounts, a line should be ruled across each account some distance below the last entry prior to the transfer, and the company's own transactions should be entered below this line, in order that the debts owing to and by the company may not be confused with those owing to and by the vendor.

If, however, the company carries on the old debtors and creditors accounts without a break, suspense accounts should be opened to provide contras in the company's books for the amounts of the vendors' debtors and creditors. Thus, in the illustration given below, since by continuing to operate upon the vendor's debtors and creditors accounts, the ledgers contain assets of £5,400 and liabilities of £3,700 which do not belong to the company, a Debtors Suspense Account must be credited with £5,400 and a Creditors Suspense Account debited with £3,700 to counteract these items. Periodically transfers are made from these suspense accounts to the Vendor's Account of amounts equal to the sums collected from debtors and paid to creditors respectively on behalf of the vendor. The amounts of any of the vendor's debtors which are written off as bad must be transferred from the company's Bad Debts Account to the debit of the Debtors Suspense Account, whilst discounts allowed and received in respect of the vendor's debtors and creditors must be transferred from the company's Discount Accounts to the appropriate suspense accounts.

Any balances remaining on the suspense accounts when the company prepares its balance sheet represent the amounts of the debtors and creditors applicable to the vendor still appearing in the company's books, and must be deducted from the totals of the debtors and creditors respectively to arrive at the figures to be shown in the company's balance sheet.

Illustration (4)

On 1st January YZ Ltd. acquired the business of X, taking over all the assets with the exception of the book debts, which it undertook to collect on behalf of X, and out of the proceeds pay the liabilities owing at the date of the transfer. At that date the book debts amounted to £5,400 and the liabilities to £3,700.

The company continued to operate on the old debtors and creditors accounts without a break, and at the following 31st December the total of the book debts amounted to £6,200, of which £400 represented debts owing to X, whilst the total creditors were £5,300, the wholeof X's liabilities having been discharged. During the year the company had written off £700 debts as bad, of which £300 was in respect of X's debtors. Discounts allowed by the company during the year amounted to £680, of which £185 was allowed to X's debtors. Discounts allowed to the company amounted to £1,400 of which £104 was in respect of pre-transfer liabilities.

Show the relevant ledger accounts in the company's books.

TOTAL DEBTORS ACCOUNT

			£				
Dec.	31	To Balance	6,200				

TOTAL CREDITORS ACCOUNT

							£
				Dec.	31	By Balance	5,300

X's DEBTORS SUSPENSE ACCOUNT

			£				£
Dec.	31	To Bad Debts Account ...	300	Jan.	1	By Balance—Debts not taken over from X	5,400
		„ Discounts Allowed Account	185				
		„ X's Account—Cash collected ...	4,515				
		„ Balance c/d.	400				
			£5,400				£5,400
				Jan.	1	By Balance b/d.	400

X's CREDITORS SUSPENSE ACCOUNT

							£
Jan.	1	To Balance—Liabilities not taken over from X	3,700	Dec.	31	By Discounts Received Account	104
						„ X's Account—Cash paid	3,596
			£3,700				£3,700

X's ACCOUNT

							£
Dec.	31	To X's Creditors Suspense Account—Cash paid to Creditors ...	3,596	Dec.	31	By X's Debtors Suspense Account—Cash received from Debtors ...	4,515
		„ Balance c/d.	919				
			£4,515				£4,515
				Jan.	1	By Balance b/d.	919

BAD DEBTS ACCOUNTS

	31	To Sundry Debtors—Debts written off	700	Dec.	31	By X's Debtors Suspense Account—Amounts applicable to X's debtors	300
						„ Profit and Loss Account ...	400
			£700				£700

DISCOUNTS ALLOWED ACCOUNT

			£				£
Dec	31	To Sundry Debtors— Discounts Allowed	680	Dec.	31	By X's Debtors Suspense Account— Discounts allowed to X's debtors	
						„ Profit and Loss Account	495
			£680				£680

DISCOUNTS RECEIVED ACCOUNT

							£
Dec.	31	To X's Creditors Suspense Account— Discounts received in respect of X's liabilities	104	Dec.	31	By Sundry Creditors Accounts Discounts Received ...	1,400
		„ Profit and Loss Account	1,296				
			£1,400				£1,400

Note

As a result of the above entries there will appear in the company's balance sheet a liability to X of £919, whilst the sundry debtors will be £5,800, *viz.*, £6,200, less the credit balance of £400 carried down in the Debtors Suspense Account. The bad debts and discounts transferred to the company's Profit and Loss Account are reduced by the amounts transferred to the suspense accounts, and thus borne by the vendor.

(b) Apportionment of Profit or Loss prior to Incorporation

In view of the inconvenience that would be caused by an additional stock-taking and the balancing off of the books when a company is formed to take over an existing business, it is common to pre-date the purchase to the date of the last balance sheet, *i.e.*, for the company to take over the business as from a date prior to its incorporation. In such an event any profits earned prior to the date of incorporation cannot be regarded as available for dividend, but are of a capital nature, since the company cannot earn profits before it comes into existence. In fact, such profits merely increase the net assets acquired by the company on its formation and come to it as capital, not revenue. When the vendor is not entitled to take such profits himself, he is usually paid interest on the purchase consideration from the date when the business was taken over to the date on which the purchase consideration is discharged. The interest payable to the vendor for the period from the date of taking over the business to the date of incorporation of the company should be charged against the profits earned during that period, any interest payable in respect of any period after the date of incorporation being charged to Profit and Loss Account. The remaining balance of profits earned prior to incorporation (if any) should either be credited to the Goodwill Account, or, if there is no Goodwill Account, applied in writing down some other asset which is deemed to be over-valued, or carried forward as a capital reserve not available for distribution.

If stock is not taken at the date of incorporation, and consequently the profits prior to that date cannot be ascertained exactly, it is usual to arrive at the profits applicable to the period either by apportioning the profits for the whole accounting period on a time basis, or in proportion to the turnover of the periods prior to and after incorporation respectively, or by a combination of these methods.

Obviously, since no business can be expected to earn its profits evenly week by week, neither the time method nor the turnover method may be entirely satisfactory. The most equitable method is normally to apportion the gross profit on the basis of the turnover, and the expenses on their respective merits, those varying with turnover being apportioned on that basis, and those which do not vary with the turnover being apportioned on a time basis.

In apportioning the profits it should be remembered that any expenditure which relates solely to the company must be charged against the profits applicable to the period subsequent to the date of incorporation. This would apply to directors' fees and other similar expenditure. On the other hand, any expense wholly applicable to the period prior to incorporation, *e.g.*, vendors' salaries, should be charged accordingly.

Any contracts entered into by a public company prior to the issue of the certificate entitling it to commence business are provisional only, but on the issue of that certificate they become binding according to their terms (§ 109 (4)), *i.e.*, they are ratified. The date of division in such cases would therefore still be the date of incorporation.

If it is found that a loss has been sustained during the accounting period the following alternative courses are open:

1. To make no apportionment at all, but to carry forward the total loss for the whole period to be written off out of subsequent profits. This is the most conservative method.

2. To debit the amount of the pre-incorporation loss to Goodwill Account. The justification for this treatment is that a loss incurred between the date as from which the business is taken over and the date of incorporation of the company reduces the net assets acquired at the date of incorporation, and thus increases the price paid for goodwill.

3. To debit the loss prior to incorporation to a suspense account, which can be subsequently written off as circumstances permit, in the same way as other fictitious assets.

Illustration (1)

The A B Co., Ltd., was formed on 1st April to take over the business formerly carried on by Messrs. Brown & Smith as from 1st January. It was agreed that all profits made subsequently to this latter date should belong to the company, but that interest on the purchase consideration (£50,000), at the rate of 6% per annum, should be paid to the vendors until the final settlement, which took place on 1st June.

The following was the Profit and Loss Account as prepared at 31st December, for the year ending on that date:

	£		£
Expenses of Management	3,050	Gross Trading Profit	20,000
Bad Debts	200		
Directors' Fees	1,000		
Interest to Vendors	1,250		
Preliminary Expenses, amount written off	500		
Depreciation	1,000		
Balance being net Profit	13,000		
	£20,000		£20,000

It was found that of the bad debts written off, £100 related to debts taken over by the company.

Apportion the profit earned as between the periods prior and subsequent to the date of incorporation, assuming the turnover to be spread evenly over the year.

	£
Net Profits	13,000
Add—	
Bad Debts	200
Directors' Fees	1,000
Interest to Vendors ...	1,250
Preliminary Expenses ...	500
	£15,950

		Prior to Incorporation.		Subsequent to Incorporation.
		£		£
Share of Profits one-quarter of £15,950		3,987		
three-quarters of £15,950 . .				11,963
Less Bad Debts	£100		£100	
Directors' Fees			1,000	
Interest to Vendors	750		500	
Preliminary Expenses .. .			500	
		850		2,100
		£3,137		£9,863

Note

The amount of £3,137 should be treated as a capital profit not available for dividend. It has been arrived at after charging the loss of £100 in respect of the diminished value of the book debts taken over.

Illustration (2)

A company was formed to take over a business as from 1st January, but was not incorporated until 30th April. The turnover for the year to 31st December was £20,000, of which £4,000 was prior to 30th April.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER

	Ratio.	Prior to Incorporation	Subsequent to Incorporation.		Ratio.	Prior to Incorporation.	Subsequent to Incorporation
		£	£			£	£
Rent, Rates and other standing charges	1 : 2	1,200	2,400	By Gross Profit b/d. . .	1 : 4	1,500	6,000
Travellers' Commission ..	1 : 4	40	160				
Discounts .	1 : 4	30	120				
Directors' Fees ..	—	—	250				
Interest on Purchase consideration . ..	—	200	50				
Net Profit to Capital Reserve	—	30	—				
Appropriation Account ..	—	—	3,020				
		£1,500	£6,000			£1,500	£6,000

Notes

1. The ratio of turnover is 4,000 : 16,000 = 4 : 16 or 1 : 4. The time ratio is four months to eight months = 1 : 2.

2. Standing charges continue irrespective of turnover, and are apportioned on a time basis.

3. Travellers' commission and discounts vary with turnover. Strictly, they may vary with the turnover of a period ending earlier than 31st December, owing to the lag in

payment, but the turnover of the period is sufficiently accurate for practical purposes unless the items are very large in amount.

4. Directors' fees do not require apportionment.

5. Interest on the purchase consideration is apportioned according to the time during which it accrued.

In some instances where a private business is transferred to a company formed for the purpose of its acquisition, it is found that no entries relating to the transfer have been made at the time, the books of the business being carried on without a break until the usual or the new accounting date. Adjustments are therefore necessary to give effect to the true position for the purposes of the final accounts.

Illustration (3)

The following is the Trial Balance of A Ltd. on 31st December:

	£	£
A—Capital Account ..		20,000
Sundry Fixed Assets ..	8,000	
Debtors ...	10,000	
Stock ..	12,000	
Cash ..	2,000	
Sundry Liabilities		8,000
Profit and Loss Account		4,000
	£32,000	£32,000

It is ascertained that on the preceding 1st March the business had been transferred to a limited company as from 1st January in consideration of £6,000 cash and £24,000 shares, the company taking over all the assets and liabilities at their book value. No entries relating to the transfer had been made in the books, nor had any entries been made in A's Capital Account since 1st January, except that he had been debited with the £6,000 cash paid to him as part of the purchase consideration.

A's Capital Account at the end of the year stands at £20,000, after having been debited with the £6,000 cash forming part of the purchase consideration, hence his capital at the beginning of the year must have been £26,000, which must therefore be the amount of the assets, less liabilities, as at 1st January, which were taken over by the company. If the company had opened a new set of books at that date, the opening journal entries would have been :

COMPANY'S JOURNAL

		£	£
Sundry Net Assets ...	Dr.	26,000	
Goodwill Account ...		4,000	
To Vendor—A ...			30,000
Vendor—A ...	Dr.	30,000	
To Cash ...			6,000
„ Share Capital Account ...			24,000

Since, instead of opening a new set of books, the company has continued to operate upon the existing asset and liability accounts, A's Capital Account can be treated as the Vendor's Account, the balance on which at the commencement of the year, £26,000, represents the credit for the net assets taken over from him. A has already received, and been debited with, £6,000 of the purchase consideration and the only entries now necessary to put the books in order are as follows :

		£	£
Goodwill Account	Dr.	4,000	
To A ...			4,000
A	Dr.	24,000	
To Share Capital Account ...			24,000
Purchase of goodwill and discharge of balance of purchase consideration.			

If any adjustment in the book value of the assets is to be made, the amount of such adjustment will be debited or credited to the particular asset accounts, and credited or debited to A's Capital Account. The effect will merely be to increase or decrease the balance of A's Account to be transferred to Goodwill Account.

As already mentioned, it is quite common, on the sale of a private business to a company, for the vendor to retain the book debts and to pay off the creditors, thus saving stamp duty on the transfer. In such cases, the company usually collects the book debts and discharges the creditors as the vendor's agent. Where the book debts and liabilities of the vendor are not taken over by the company, the balance of the vendor's capital account at the date as from which the business is transferred does *not* represent the net assets taken over by the company under the agreement until the debtors and creditors at that date have been eliminated therefrom. Strictly, therefore, the vendor's account should be debited and the various debtors' accounts credited with the amount of the sundry debtors at the date of the transfer of the business; and the sundry creditors' accounts debited and the vendor's account credited with the liabilities not taken over by the company in order to eliminate from the company's books assets and liabilities not taken over. As the amounts are collected from debtors and paid to creditors, they would be debited and credited respectively to the cash book, and credited and debited respectively to the vendor's account, the balance of which would then represent the balance to be accounted for by the company to the vendor, or *vice versa*. Frequently, in practice, only differences will be adjusted, but great care must be taken, if such a short cut is adopted, to ensure that the final result is accurate.

If the company has continued to post to the old debtors' and creditors' accounts as if no change had taken place, the actual personal accounts of debtors and creditors will have been credited and debited during the period following the transfer with the cash received and paid by the company respectively, and the above entries will not be practicable. It is then necessary to create suspense accounts, as indicated below.

Illustration (4)

Assume that in Illustration (3) the debtors and creditors amounting on 1st January to £8,000 and £6,000 respectively, were not taken over by the company, but were collected and paid by them as agent for the vendor, and that the old accounts were continued by the company without a break, the debts being collected during the year, subject to discounts of £400, and the creditors paid, subject to discounts of £150.

COMPANY'S JOURNAL

		£	£
A's Account	Dr.	8,000	
To Debtors' Suspense Account ...			8,000
Creditors' Suspense Account	Dr.	6,000	
To A's Account			6,000
Adjusting debtors and creditors not taken over.			

The above entries reduce the credit on A's account to £18,000 and thereby increase the price paid for goodwill to £6,000.

At the end of the period, when the amounts collected from debtors and paid to creditors have been ascertained, the following further entries will be necessary :

		£	
Debtors Suspense Account	Dr.	8,000	
To A's Account			7,600
Discount Allowed Account . .			400
Debts collected and discounts allowed on behalf of vendor.			
A's Account . . .	Dr	5,850	
Discount Received Account		150	
To Creditors Suspense Account			6,000
Liabilities paid and discounts received on behalf of vendor.			

A's Account will then be closed by the payment to him of £1,750 cash, being the excess of receipts over payments. It will be seen that by the above entries the discounts allowed and received respectively on behalf of the vendor have been eliminated from the company's discount accounts, but the personal accounts of the debtors and creditors are not affected.

Illustration (5)

XY, the proprietor of a business, wishing to realise part of his capital, decided to convert his business into a limited company as from 1st January, and invite his friends to take up shares.

The company was duly incorporated on 1st February, on which date 9,000 shares of £1 each were issued for cash, XY retaining the remaining 1,000 shares as part consideration.

Out of the proceeds of the issue, XY was paid £7,000 as the balance of the purchase price and £750 for outlays incurred by him connected with the company's incorporation.

XY agreed to be manager of the company, as from 1st January, at a salary of £500 per annum.

It was not considered necessary to open up a new set of books and accounts.

The Trial Balance, before adjustment, at 31st December is as follows :

	£	£
Capital Account (XY)	1,250	
New Company Account (XY & Co Ltd.)		9,000
Sales .		30,000
Stock Account . . .	22,900	
Wages and Salaries .	2,750	
Other Expenses .. .	2,500	
Bad Debts written off during year	175	
Sundry Creditors . . .		3,325
Sundry Debtors .	5,000	
Property ...	6,000	
Cash on hand and in Bank	1,750	
	£42,325	£42,325

XY has not been credited with salary to date nor has he received anything on account. Interest on the purchase price at 5 per cent., falls to be credited to him as from 1st January to the date of settlement. The Stock at 31st December is valued at £400.

A re-valuation at 1st January showed that the property was worth £6,500, and that £250 of the debts were doubtful or bad. Against the latter it was agreed to provide £200.

Actually only debts to the value of £100 have proved to be bad, the balance having been collected by the company.

XY's capital at 1st January was £6,500.

Prepare Balance Sheet of XY & Co. Ltd. as at 31st December with relative Profit and Loss Account to that date, giving effect to the adjustments necessary, but yet unrecorded, on account of the change of ownership. Ignore income tax.

TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 19

				£
To Stock Account ..	£22,900		By Sales	30,000
Less Stock in Hand	400			
		22,500		
,, Gross Profit c/d.		7,500		
		£30,000		£30,000
		£		£
To Wages and Salaries		2,750	By Gross Profit b/d.	7,500
,, Manager's Salary		500		
,, Other Expenses		2,500		
,, Bad Debts ...		75		
,, Net Profit c/d.		1,675		
		£7,500		£7,500
To Interest on purchase price at 5% on £8,000 prior to incorporation, 1 month		34	By Net Profit b/d.— Prior to Incorporation, 1 month	140
,, Net Profit prior to incorporation carried to Capital Reserve		106	After Incorporation, 11 months	1,535
,, Net Profit carried forward ...		1,535		
		£1,675		£1,675

XY LTD, BALANCE SHEET AS AT 31ST DECEMBER, 19

		£	*Fixed Assets* :—			
Share Capital, authorised, issued and fully paid		10,000	Goodwill	£1,200		
Capital Reserve—			*Less* Capital Reserve *per contra*	206		
Profits prior to Incorporation	£106				994	
Balance of Bad Debt Provision on debts taken over	100		Property at cost		6,500	
						7,494
Deducted *contra* from Goodwill	£206		*Current Assets* :—			
			Stock ..		400	
			Debtors .. .		5,000	
			Cash on hand and in Bank		1,750	
Profit and Loss Account		1,535				7,150
		11,535	Preliminary Expenses			750
Sundry Creditors		3,325				
XY—Salary and Interest		534				
		£15,394				£15,394

Notes

(1) The account of XY will be adjusted as follows:

XY (VENDOR)

		£				£
Feb 1	To Cash	7,750	Jan 1	By Balance (capital)		6,500
			Dec. 31	,, Balance c/d. (as per Trial Balance)		1,250
		£7,750				£7,750
Jan. 1	To Balance b/d.	1,250	Dec. 31	By Property Account—Increase in value		500
	,, Share Capital Account—Shares issued as part consideration	1,000		,, Preliminary Expense Account amounts paid by XY ...		750
	,, Bad Debt Provision	200		,, Balance, being cost of Goodwill debited to Goodwill Account		1,200
		£2,450				£2,450

(2) PROVISION FOR BAD DEBTS ACCOUNT

	£		£
To Bad Debts written off	100	By XY—Provision created at acquisition of business	200
Balance—excessive Provision transferred to Capital Reserve	100		

By debiting £100 of the bad debts written off against the provision for bad debts, only £75 remains to be debited to Profit and Loss Account as representing bad debts incurred by the company. The balance of the provision for bad debts taken over from the vendor may now be treated as a capital reserve and deducted from the cost of goodwill.

(3) In the absence of information as to the incidence of sales, the gross profit and the Profit and Loss Account items have all been apportioned between the periods prior to and after incorporation on a time basis. Strictly the gross profit and other items varying with turnover should be apportioned on the basis of turnover.

Illustration (6)

Ernest Dundas and Arthur Banbury were in partnership as Ernest Dundas & Co., sharing profits and losses as 20 to 17.

Accounts were prepared and the books closed off as at 31st December, 19...

On the following 1st May, Dundas & Banbury, Ltd., was registered to acquire the business of Ernest Dundas & Co. as from the 1st January.

The sale and purchase agreement provides :

(*a*) Purchase consideration 6,000 Preference shares £1 each fully paid.
6,000 Ordinary shares 2/- each fully paid.

(*b*) Vendors to retain cash and debtors and to pay off liabilities.

(*c*) Each of the vendors to subscribe in cash for one-half of the balance of authorised capital, 850 Preference shares and 500 Ordinary shares.

The articles of association appoint E. Dundas and A. Banbury sole directors with fees of £100 per month each.

You are requested to assist the directors in the preparation of accounts to 30th September. You find that the books have been carried on without a break since 1st January, and that no entries arising from the formation of the company or its acquisition of the business have been made.

The Trial Balance at 30th September was as follows :-

	£	£
A. Banbury—Capital at 1st January		2,860
Drawings during period	250	
E. Dundas Capital at 1st January		3,000
Drawings during period	300	
E. Dundas and A. Banbury for shares		900
Buildings	3,800	
Creditors (£1,500 owing at 1st January, having been paid)		700
Debtors (£1,000 due at 1st January, having been received)	950	
Formation of Company Expenses	150	
Furniture and Fittings (Balance at 1st January, £360)	460	
Office Expenses	350	
Plant and Machinery (Balance 1st January, £1,200)	1,500	
Purchases	2,000	
Sales ...		8,200
Salaries	400	
Selling Expenses	600	
Stock 1st January	500	
Wages	800	
Cash (Balance at Bank at 1st January, £500)...	3,600	
	£15,660	£15,660

You obtain the following additional information:

E. Dundas and A. Banbury have agreed between themselves to take preference shares for the amount of their capital at 1st January.

The average of the monthly sales (which are of one commodity at a fixed price) for the first four months was one-half that of the remainder of the period.

The expenditure each month on items in the Profit and Loss Account was equal.

The stock at 30th September is valued at £700.

Plant and machinery is to be depreciated at 5% per annum, and furniture and fittings at 10% per annum, in both cases on commencing figures.

Preliminary expenses are to be written off.

You are required—

(i) To prepare the journal entries necessary to put the books in order.

(ii) To show the shareholdings acquired by the partners.

(iii) To prepare the company's Trading and Profit and Loss Account, and Balance Sheet as at 30th September.

Ignore income tax.

(i) JOURNAL

		£	
Capital Accounts :	*Dr.*		
A. Banbury ...		2,860	
E. Dundas		3,000	
To Vendors			5,860
Transfer of Capital at 1st January.			
Goodwill ...	*Dr.*	740	
To Vendors			
Excess of purchase consideration over value of net assets.			
Vendors	*Dr.*	6,600	
To Preference Share Capital Account			6,000
Ordinary Share Capital Account			600
Issue of 6,000 Preference Shares of £1 each, fully paid, and 6,000 Ordinary Shares of 2s. each, fully paid, in satisfaction of purchase consideration.			
E. Dundas and A. Banbury	*Dr.*	900	
To Preference Share Capital Account			850
Ordinary Share Capital Account			50
Issue of 850 Preference Shares of £1 each, fully paid and 500 Ordinary Shares of 2s. each, fully paid, as per application received.			

Note

The cash at bank on 1st January has been applied in settlement of the difference between the debtors and creditors outstanding at that date, and which have subsequently been received and discharged.

(ii) SHAREHOLDINGS OF PARTNERS

	E. Dundas.	A. Banbury
	£	£
Capital Accounts, 1st January	3,000	2,860
Profit on sale of firm	400	340
Cash subscribed for shares	450	450
Amount to be discharged	£3,850	£3,650
	Shares.	Shares.
Preference shares for capital	3,000	2,860
Preference shares subscribed	425	425
Balance of preference shares allotted in profit-sharing ratio	76	64
Total Preference shares	3,501	3,349
Ordinary shares subscribed	250	250
Balance of ordinary shares allotted in profit-sharing ratio	3,243	2,757
Total Ordinary Shares	3,493	3,007

SUMMARY.

	E. Dundas.		A. Banbury.	
	Shares.	£ s. d.	Shares.	£ s. d
Ordinary	3,493	349 6 0	3,007	300 14 0
Preference	3,501	3,501 0 0	3,349	3,349 0 0
		£3,850 6 0		£3,649 14 0

A cash payment of 6/- must be made by Dundas to Banbury.

(iii)

TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE 9 MONTHS ENDED 30TH SEPTEMBER, 19..

	£	£		£
To Stock, 1st January		500	By Sales .. .	8,200
Purchases		2,000	„ Stock, 30th September	700
Wages...		800		
Gross Profit :				
Prior to Incorporation (two-sevenths)	1,600			
Subsequent to Incorporation (five-sevenths) ..	4,000			
		5,600		
		£8,900		£8,900

	£	Profits Prior to Incorporation (4 months).	Profits Subsequent to Incorporation (5 months).		Profits Prior to Incorporation	Profits Subsequent to Incorporation
	£	£	£		£	£
Salaries .	400			By Gross Profit b/d.	1,600	4,000
Office Expenses	350					
Selling Expenses	600					
Depreciation :						
Plant ...	45					
Furniture .	27					
	£1,422	632	790			
Directors' Fees			1,000			
Formation Expenses .			150			
Capital Reserve . .		968				
Balance c/f.			2,060			
		£1,600	£4,000		£1,600	£4,000

BALANCE SHEET

AS AT 30TH SEPTEMBER, 19..

Share Capital :			*Fixed Assets* :—		£	
Authorised and Issued :			Goodwill at cost . ..		740	
6,850 Preference Shares of £1 each, fully paid	£6,850		Buildings at cost . . .		3,800	
6,500 Ordinary Shares of 2s. each, fully paid	650		Plant and Machinery, at cost	£1,500		
		7,500	*Less* Depreciation ..	45		
Capital Reserve . .		968			1,455	
Profit and Loss Account		2,060	Furniture and Fittings at cost	460		
		10,528	*Less* Depreciation .. .	27		
					433	
						6,428
Sundry Creditors :			*Current Assets* :—			
Trade ..	£700		Stock		700	
Directors' Fees	450		Sundry Debtors		950	
		1,150	Cash at Bank		3,600	
						5,250
		£11,678				£11,678

Notes

1. The drawings made by the partners since 1st January, have been applied in part payment of the directors' fees accruing to them since 1st May, leaving £450 directors' fees still outstanding.

2. The formation expenses may, alternatively, be written off against the profits prior to incorporation.

3. Since the average of the monthly sales for the first four months was one-half that of the remainder of the period, the proportion of turnover is 2 : 5.

	s.	d
0	14	0
9	0	0
9	14	0

Illustration (7)

A and B, trading in partnership, shared profits and losses in the proportions A three-fifths and B two-fifths. On 1st June they executed an agreement for the sale to a company,

AB Ltd., as on the previous 1st April, of the following assets for a consideration of £120,000 allocated as follows: Goodwill £25,000, Freehold Land and Buildings £60,000, Plant and Machinery, £30,000, Stocks £5,000.

The company was incorporated on 1st June, with an authorised capital of £250,000 in shares of £1 each, of which 120,000 were issued forthwith in satisfaction of the purchase consideration. The business was deemed to have been carried on by the vendors on behalf of the purchasers from 1st April, and A and B, whose last accounts were made up to 31st March, continued their book-keeping records to 30th June without regard to the sale of the assets, although, for the month of June, sales had been invoiced and purchases ordered in the name of AB Ltd.

The following Trial Balance was drawn up from the books of A & B as on 30th June:

Debits.	£	*Credits.*	£
Goodwill	9,000	Creditors (including £3,000 for June purchases)	5,500
Freehold Land and Buildings	25,000	Sales	50,000
Plant and Machinery (including £2,000 purchased since 31st March)	22,000	Discounts	300
Stock as on 31st March,	5,000	Capital Account—A	35,000
Debtors (including £4,000 for June sales)	6,000	B	25,000
Wages and Salaries (including Directors' Fees, £200)	20,000	Current Account—A	300
Rent	200		
Purchases	18,000		
A.B. Ltd. Account	7,000		
Discounts	600		
Expenses	2,000		
Current Account, B	800		
Balance at Bankers	500		
	£116,100		£116,100

Stocks were valued by the company's officials on 30th June at £4,000.

The balance of £7,000 on AB Ltd. account represented cash paid for 7,000 shares of £1 each allotted to A & B on 1st June, which was paid by them into a banking account in the name of AB Ltd. on that date. Cheques were drawn on this account on 28th June to pay for Preliminary and Formation Expenses, £1,500, and for Office Furniture, £500. On 30th June the account was credited with £10 for interest allowed by the Bank.

A & B were to pay for purchases made prior to 1st June, and debtors for sales before that date were paid to A. & B. There were no purchases or sales for cash. Trading profits accrued regularly over the period.

You are required:

(*a*) to show the account of AB Ltd. as it should be written up in the books of A & B, ignoring interest;

(*b*) to prepare the Balance Sheet of A & B as on 30th June; and

(*c*) to prepare the Profit and Loss Account of AB Ltd. for the 3 months ended 30th June, and the Balance Sheet as on that date, ignoring depreciation and taxation;

In this case, although the business was sold to the company as from 1st April, the books of the partnership were not closed, but the firm carried on the business on behalf of the company, recording the transactions through its own accounts. As at 30th June the balances of all accounts representing payments and expenses incurred and sales made on behalf of the company must be transferred to the company's account in the firm's books. This account must also be debited with the transfer price of the assets sold to the company, the balances on the asset accounts, representing profit on realisation, being divided between the partners in profit-sharing ratio and credited to their capital accounts. The balance of the company's account will then represent the amount due by the firm to the company as a result of all these transactions.

BOOKS OF A AND B

A B LTD.

	£		£
Cash for 7,000 Shares in A B Ltd.	7,000	By Shares in A B Ltd. ...	127,000
Goodwill	25,000	,, Creditors (for June Purchases)	3,000
Freehold Land and Buildings	60,000	,, Sales ...	50,000
Plant and Machinery	32,000	,, Discounts received ...	300
Stocks	5,000		
Debtors (June Sales)	4,000		
Wages and Salaries	20,000		
Rent ...	200		
Purchases	18,000		
Discounts allowed	600		
Expenses	2,000		
Balance c/f	6,500		
	£180,300		£180,300
		By Balance b/f. ...	6,500

Note

The company is debited with all purchases and credited with all sales to date, but since A and B are only to pay for purchases, and receive payments from debtors for sales prior to 1st June, the creditors for purchases and debtors for sales after 1st June are transferred to the company. A and B will themselves pay the creditors for purchases, and receive the amounts due from debtors in respect of sales prior to 1st June, having charged the company with these purchases and credited it with these sales.

(b) A AND B

BALANCE SHEET AS AT 30TH JUNE

	£	£		£
A—Capital Account	71,600		Shares in A B Ltd.	127,000
Current Account	300		Debtors	2,000
		71,900	Balance at Bank	500
B—Capital Account	49,400			
Current Account *Dr.*	800			
		48,600		
		120,500		
A B Ltd		6,500		
Trade Creditors		2,500		
		£129,500		£129,500

Note: The partners' Capital Accounts are as follows :

	A.	B		A.	B
	£	£		£	£
To Balance c/f	71,600	49,400	By Balance c/f.	35,000	25,000
			,, Profit on realisation	36,600	24,400
	£71,600	£49,400		£71,600	£49,400
			By Balance b/f	71,600	49,400

The profit on realisation is:

Consideration for assets—	Goodwill		£25,000
	Land and Buildings		60,000
	Plant and Machinery		30,000
	Stocks		5,000
			120,000
Less Book Values—	Goodwill	£9,000	
	Land and Buildings ...	25,000	
	Plant and Machinery ...	20,000	
	Stock	5,000	
			59,000
Profit—divisible A 3/5ths, B 2/5ths			£61,000

A B LTD.
TRADING AND PROFIT AND LOSS ACCOUNT
FOR 3 MONTHS ENDED 30TH JUNE

(c)

		£			£
To Stock, 1st April		5,000	By Sales		50,000
„ Purchases		18,000	„ Stock, 30th June		4,000
„ Gross Profit c/d.		31,000			
		£54,000			£54,000
	Prior to Incorporation £	Since Incorporation £		Prior to Incorporation £	Since Incorporation £
To Wages and Salaries	13,200	6,600	By Gross Profit b/d.	20,667	10,333
„ Directors' Fees		200	„ Discounts	200	100
„ Rent	133	67	„ Bank Interest		10
„ Discounts	400	200			
„ Expenses	1,334	666			
„ Profit prior to Incorporation transferred to Capital Reserve	5,800				
„ Net Profit since Incorporation c/f.		2,710			
	£20,867	£10,443		£20,867	£10,443

Note. Gross profit and expenses which move with turnover should more correctly be apportioned on the basis of sales.

BALANCE SHEET AS AT 30TH JUNE

	Authorised £	Issued and fully paid £		£	£
Share Capital: ...			Fixed Assets, at cost:		
Shares of £1 each	250,000	127,000	Goodwill	25,000	
			Freehold Land and Buildings...	60,000	
Capital Reserve ...	5,800		Plant and Machinery .	32,000	
Less Preliminary Expenses written off	1,500		Office Furniture	500	
		4,300			117,500
Profit and Loss Account		2,710	Current Assets:		
			A & B .	6,500	
			Stocks	4,000	
		134,010	Trade Debtors	4,000	
Creditors		3,000	Cash at Bank .	5,010	
					19,510
		£137,010			£137,010

Notes

1. The following journal entries will be necessary to open the company's books:

JOURNAL

		£	
Cash	*Dr.*	7,000	
Goodwill		25,000	
Freehold Land and Buildings		60,000	
Plant and Machinery ...		30,000	
do. Additions		2,000	
Stock		5,000	
Debtors (for June Sales) .		4,000	
Wages and Salaries ...		19,800	
Directors' Fees		200	
Rent		200	
Purchases		18,000	
Discounts allowable ...		600	
Expenses		2,000	
To A & B			173,800
		£173,800	£173,800
Assets taken over from, and expenses paid and incurred by A & B on behalf of the company.			
A & B	*Dr.*	180,300	
To Share Capital ...			127,000
Creditors (for June Purchases)			3,000
Sales			50,000
Discounts receivable ...			300
		£180,300	£180,300
120,000 Shares issued to A & B as purchase consideration and 7,000 for cash, liabilities assumed from and sales made by A & B on behalf of the company.			

2. The company's bank balance is made up as follows:

Paid in by A & B		£7,000
Bank Interest		10
		7,010
Less Preliminary Expenses	£1,500	
Furniture	500	
		2,000
		£5,010

§ 12. Bonus Shares

(a) Issue of Bonus Shares

When a company has a large amount of undistributed profits, either on Reserve Account or on Profit and Loss Account, the real capital employed in the business tends to be obscured. Usually, such accumulations will have been employed in the acquisition of fixed assets, and as working capital, which will be required permanently. To bring the issued share capital into a truer relationship with the capital actually employed in the business, the accumulations can be capitalised and applied in paying up the amounts due on shares to be issued to the members as bonus shares.

No cash passes between the company and its members in respect of these transactions, the resolution to pay the bonus being so framed as to give the company authority to apply the bonus in paying up the shares.

A bonus issue of shares adds nothing to the net assets of the company, and its effect, therefore, is merely to divide the capital employed in the business into a larger number of shares. Nevertheless, it is usual to find that where the shares are quoted on the stock exchange, the issue of bonus shares is a bull point, which forces up the market value of the shares and enables the shareholders who wish to do so to realise an immediate profit. This can be explained by an illustration.

Illustration (1)

A company's summarised Balance Sheet is as follows:

SHARE CAPITAL in £1 Shares ..	£100,000	SUNDRY ASSETS, *less* Creditors ..	£150,000
REVENUE RESERVES ..	50,000		

If the assets and goodwill are fully valued, each £1 share is worth £1 10s. 0d. *cum* dividend. On the profits being capitalised, if the bonus shares are issued at par, the share capital becomes £150,000 in £1 shares. Each share is now worth £1, but each shareholder has 50 per cent. more shares. The shareholders are no better off.

In few cases, however, will the net assets as shewn in the balance sheet reflect the true market value of the shares, which will depend primarily on the income they yield. The company may have paid a dividend of 12 per cent. and if a reasonable yield were 6 per cent. the shares would be quoted round about £2 each, and the total value of the capital would be £200,000. The real value of the shares after the bonus issues would still be £200,000, or £1 6s. 8d. each, if it is anticipated that the company will only distribute the same amount of profits as before and will reduce the rate of dividend

proportionately, *i.e.*, to 8 per cent. The market, however, will usually gamble on the dividend not being reduced so much, and may quote the shares at, say, £1 10s. 0d. or £1 15s. 0d. in the expectation of 9 per cent. or more being paid. A member who shares in this expectation might then sell part of his shares, while retaining the anticipation of the same income.

It is obvious that the distribution of bonus shares cannot always be effected without complications arising from fractions. The distribution may be on the basis of, say, one bonus share for every five held, in which case the holder of 24 shares would be entitled to four complete shares and four-fifths of a share, which must be made up to a complete share by the acquisition of the title to a further one-fifth of a share before registration can finally be effected. This difficulty is normally overcome in one of two ways, viz.:

1. The articles and the resolution voting the bonus issue may provide for each shareholder to be allotted the whole number of shares appropriate to his holding. The shares representing the sum of the fractions are then sold, and the proceeds paid to the shareholders entitled to the fractions.

2. Members may be notified that they must either acquire or surrender fractions at a stated price before a specified date, such exchange generally being arranged through the medium of the secretary (the directors having previously arranged for one or more large shareholders to be ready to acquire any rights not otherwise disposed of) unless the rights are saleable on the stock exchange. Fractional 'certificates' are frequently issued to the members affected, to facilitate transfer within the period allowed. These certificates are not share certificates, but merely certificates of 'rights'.

Sometimes, it is left to the members to deal with their fractions, in which case any fractions outstanding on the prescribed date are cancelled. This is not recommended, as it is to the detriment of shareholders, and the effect is that the whole bonus is not allotted.

In other cases, the articles empower the directors to issue the nearest whole number of shares. This again is unsatisfactory, as the whole profits intended to be capitalised are not so applied.

Illustration (2)

A company having a reserve of £25,000 and a paid-up capital of £100,000 in £1 shares, resolves to pay a bonus of 20 per cent. out of its reserve by the issue of one fully-paid share for each 5 shares held. Show the journal entries recording the transaction.

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		£	£
Reserve Account	Dr	20,000	
To Bonus Account			20,000
Being Bonus of 20% payable out of the Reserve Account in fully-paid shares as per Resolution dated			
Bonus Account	Dr.	20,000	
To Share Capital Account			20,000
Being issue of 20,000 shares of £1 each fully paid in satisfaction of Bonus at the rate of one share for every five held.			

(b) Application of Bonus to payment of calls

Another method, when the existing shares are only partly called up, is to apply the bonus to the payment of a call on the shares.

Illustration (3)

A company having a nominal and issued capital of £100,000 in 10,000 shares of £10 each, £7 10s. 0d. per share called up, declares a bonus out of the reserve account at the rate of 33⅓ per cent. on the paid-up capital, to be applied for the purpose of making the shares fully paid.

Show the journal entries necessary to record these transactions.

JOURNAL

		£	£
Call Account	Dr	25,000	
To Share Capital Account .			25,000
Being final call of £2 10s. per share on 10,000 shares as per Resolution of the Board dated			
Reserve Account . .	Dr.	25,000	
To Bonus Account			25,000
Being Bonus of £2 10s. per Share on 10,000 shares payable out of the Reserve Account as per Resolution of shareholders dated.... .			
Bonus Account	Dr.	25,000	
To Call Account			25,000
Being application of Bonus of £2 10s. per share on 10,000 shares to payment of Call as per Resolution dated			

§ 13. Payment of Interest out of Capital

Although a company can, indeed must, pay interest out of capital, where there are no profits out of which to pay it, to meet its obligations in respect of debentures and loans, it is a rule of law that no interest can be paid to members on the share capital of the company (except interest on moneys paid in advance of calls). The only exception to this rule is that provided by Section 65, whereby, to enable companies to construct works or buildings or provide plant with money raised as share capital, interest may be paid to members out of capital in the following circumstances:

Where any shares of a company are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings, or the provision of any plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is for the time being paid up for the period and subject to the conditions and restrictions mentioned below, and may charge such interest to capital as part of the cost of construction of the work or buildings, or the provision of plant.

The conditions and restrictions are that:

(1) no such payment shall be made unless it is authorised by the articles, or by special resolution;

(2) no such payment, whether authorised by the articles or by special resolution, shall be made without the previous sanction of the Board of Trade;

(3) before sanctioning any such payment the Board of Trade may, at the expense of the company, appoint a person to inquire and report to them as to the circumstances of the case, and may, before making the appointment, require the company to give security for the payment of the costs of the inquiry;

(4) the payment shall be made only for such period as may be determined by the Board of Trade, and that period shall in no case extend beyond the close of the half year next after the half year during which the works or buildings have been actually completed or the plant provided;

(5) the rate of interest shall in no case exceed 4 per cent. per annum, or such other rate as may for the time being be prescribed by statutory instrument*;

(6) the payment of such interest shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid;

(7) the accounts of the company shall show the share capital on which, and the rate at which, interest has been paid out of capital during the period to which the accounts relate (8th Sch., Pt. I, § 2).

It should be observed that the payment of 'interest' is not a dividend; it is definitely interest on the shares pending the completion of the work which is designed to earn profits out of which dividends will thereafter be payable. The interest is to be treated as capital expenditure and debited to the asset account in respect of which it is paid. The debit will be the gross amount, since the income tax deductible will be paid over to the Inland Revenue under Sec. 170, Income Tax Act, 1952. Interest is only payable on the paid-up amount of the shares.

§ 14. The Preparation of a Company's Books and Accounts for Audit

Proper arrangements should always be made to facilitate as much as possible the work of the auditor and to enable him to examine the books and accounts with the least amount of inconvenience to himself and to the company's staff.

First and foremost, a proper system of accounting must be in force. The books must be balanced, since it is not the duty of an auditor to balance them, nor can he be called upon to do so, unless separately instructed in his capacity as accountant. All subsidiary books should be cast in ink, and the totals posted to the proper accounts in the impersonal ledger. The various bought and sold ledgers should be proved individually by means of Total (or Control) Accounts, and their balances brought down in ink, or, if it is inconvenient to rule off and bring down such balances, a note of the amount of the balance should be made on each ledger account in red ink at the side. (This will, of course, be unnecessary where machine accounting is employed, as the balance will be extended into the balance column of the accounts after each entry.)

The cash book should be balanced off and a record of the reconciliation of the balance with the pass book or bank statement entered in it. All vouchers should be numbered consecutively, and the numbers entered in the cash book, the vouchers themselves being filed on some proper system, care being taken to see that, in the event of a voucher being missing, a note is inserted in the file, giving a reference to any other evidence available. Bought invoices should either be attached to the statements when filed as vouchers, or should be numbered and filed consecutively, the corresponding numbers being entered in the bought journal.

When the Trial Balance has been extracted, proper provision must be made for bad debts, depreciation, etc., and all other necessary adjustments must be made. The Balance Sheet and Profit and Loss Account can then be drafted, and, after having been passed by the directors, presented to the auditor. In many cases it is usual for the auditor to prepare the accounts himself, in the capacity of accountant.

*The rate at present allowable is 6 per cent.

Any important provisions and reserves, *e,g,*, for contingent liabilities, revaluations of fixed assets, etc., should be supported by directors' minutes.

In the final accounts, ledger folios should be inserted against each item which refers to a single ledger account, schedules being attached showing folios and details of all items composed of several balances taken collectively. In this manner a full and clear record is obtained of the way in which the various totals, particularly of Balance Sheet items, are arrived at.

§ 15. The Balance Sheet and Accounts of a Company

(a) The Books of Account

By Section 147 (1) of the Companies Act, 1948, every company must keep proper books of account with respect to:

(*a*) all sums of money received and expended by the company, and the matters in respect of which the receipt and expenditure takes place;

(*b*) all sales and purchases of goods by the company;

(*c*) the assets and liabilities of the company.

A company will not be deemed to have kept proper books of account unless it has kept such books as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions.

The books of account are to be kept at such office as the directors think fit, and are to be always open for their inspection. If books are kept at a place outside Great Britain there must be sent to and kept at a place in Great Britain, and be at all times open to the inspection of the directors, such accounts and returns with respect to the business dealt with in those books as will disclose with reasonable accuracy the financial position of that business, at intervals not exceeding 6 months, and will enable to be prepared in accordance with the Act the company's Balance Sheet and Profit and Loss Account or Income and Expenditure Account and any documents required to be annexed thereto (§ 147 (3)).

If any director of the company fails to take all reasonable steps to secure compliance with the above provisions, or has by his own wilful default been the cause of any default by the company thereunder, he may, in respect of each offence, be liable, on summary conviction, to imprisonment for a term not exceeding 6 months, or to a fine not exceeding £200. It will be a defence, however, for the director to prove that he had reasonable ground to believe, and did believe, that a competent and reliable person was charged with the duty of seeing that the requirements were complied with and was in a position to discharge that duty; and a person shall not be sentenced to imprisonment for such an offence unless in the opinion of the Court, the offence was committed wilfully (§ 147 (4)).

If, when a company is wound up, it is shown that proper books of account have not been kept throughout the two years immediately preceding the commencement of the winding-up, every officer of the company who is in default shall, unless he shows that he acted honestly and that in the circumstances in which the business was carried on the default was excusable, be liable on conviction on indictment to

imprisonment for not more than one year, or, on summary conviction, for not more than 6 months. For this purpose, proper books of account include, in addition to the books already mentioned, books containing entries from day to day in sufficient detail of all cash received and paid, and, where the business involves dealing in goods, statements of the annual stocktakings, and (except in the case of retail sales) of all goods sold and purchased, showing the goods and the buyers and sellers thereof in sufficient detail to enable the goods and the buyers and sellers to be identified (§ 331).

(b) The Profit and Loss Account and Balance Sheet

By Section 148 the directors of every company shall at some date not later than eighteen months after the incorporation of the company, and subsequently once at least in every calendar year, lay before the company in general meeting:

(1) a Profit and Loss Account, or, in the case of a company not trading for profit, an Income and Expenditure Account; and

(2) a Balance Sheet as at the date to which the Profit and Loss Account or the Income and Expenditure Account, as the case may be, is made up.

This date must be not more than nine months or, in the case of a company carrying on business or having interests abroad, not more than twelve months earlier than the date of the meeting.

The Profit and Loss Account, or Income and Expenditure Account, must be for the period:

(1) in the case of the first account, since the incorporation of the company; and

(2) in any other case, since the preceding account.

These periods may be extended by the Board of Trade if for any special reason they think fit so to do.

The penalties for failure to comply with these provisions, and the defences available in respect of an offence under this section are similar to those referred to in § 147 (4) in respect of the failure to keep proper books of account (*see ante*).

Every Balance Sheet of a company must give a true and fair view of the state of affairs of the company as at the end of its financial year, and every Profit and Loss Account must give a true and fair view of the profit or loss for the financial year (§ 149 (1)).

The contents of the Balance Sheet and Profit and Loss Account must be such as will comply with the requirements of the Eighth Schedule of the Act, so far as applicable thereto, but the Board of Trade may, on the application or with the consent of a company's directors, modify any of the requirements of the Act, as to the matters to be stated in the Balance Sheet and Profit and Loss Account, for the purpose of adapting them to the circumstances of the company (§ 149 (2) and (4).

Subject to the requirements of the Act, the amount of detailed information disclosed in the published accounts must be carefully considered, as it should not be such as to injure the company by affording valuable information to trade rivals, *e.g.*, it is not usual to find a published Trading Account disclosing turnover, although some of the larger concerns do nowadays publish this information in notes on the accounts.

The provisions of Section 149 (1) and (2) as to the *contents* of the Profit and Loss Account do not apply if:

(*a*) the company has subsidiaries; and

(*b*) the Profit and Loss Account is framed as a consolidated Profit and Loss Account, dealing with all or any of the company's subsidiaries as well as the company, and:

(i) complies with the requirements of the Act relating to consolidated Profit and Loss Accounts; and

(ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company (§ 149 (5)).

The following definitions are given in Part IV of the Eighth Schedule for use in relation to matters required by that Schedule to be disclosed in the Balance Sheet and Profit and Loss Account:

(1) (*a*) the expression 'provision' shall, subject to (2) below, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(*b*) the expression 'reserve' shall not, subject to (2) below, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability (and the expression 'liability' shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities);

(*c*) the expression 'capital reserve' shall not include any amount regarded as free for distribution through the Profit and Loss Account, and the expression 'revenue reserve' shall mean any reserve other than a capital reserve;

(2) Where:

(*a*) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before 1st July, 1948; or

(*b*) any amount retained by way of providing for any known liability;

is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not as a provision.

(3) The expression 'quoted investment' means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, or on any stock exchange of repute outside Great Britain, and the expression 'unquoted investment' shall be construed accordingly.

It will be recognised from the above definitions that the meaning given to the expression 'provision' is much narrower than that usually attributed to it in framing accounts. For the purposes of the Companies Act, the word 'provision' must not be used, as it commonly is used in practice, to describe amounts set aside to provide for prospective or even potential losses or liabilities; it must only be employed to indicate *known* depreciation or diminution in the value of assets, and *known* liabilities, the amount of which, however, cannot be estimated with reasonable accuracy. If the amount of a known liability *can* be estimated with substantial precision, it must be classified as a liability, and not as a provision. The sum which it is customary and prudent to set aside for the purpose of meeting United Kingdom income tax based on the current year's profits must not be called a provision since it is not a liability at the

date of the Balance Sheet but is an amount set aside to provide for a liability which will arise in the following year.

There is in fact no universally accepted practice in describing in a company's balance sheet amounts set aside for this purpose. Shortly after the passing of the Companies Act, 1948, the Council of the Institute of Chartered Accountants recommended that as such amounts could not be classified as liabilities or provisions they should be treated as reserves. In a more recent recommendation, however, the Council appear to have modified this view. They point out that whilst some companies treat these amounts as specific reserves and group them with reserves in their balance sheet, an increasing number of others show them separately under descriptions such as 'Amounts set aside for future income tax' without attaching the description of reserve or aggregating them with their reserves. The latter procedure has manifest practical advantages, especially that of separating reserves which are within the free disposition of the company from amounts which will normally be payable at some future date. Accordingly, the Council do not now insist on amounts set aside for future income tax being treated as reserves. They recommend, however, that whether described as reserves or not, such amounts should be shown separately and should preferably *not* be aggregated with reserves.

It will also be observed that where any amount set aside as a provision is greater than the amount which, in the opinion of the directors, is reasonably necessary for the purpose, the excess must be shown in the accounts as a reserve, not as a provision. This, however, does not apply to amounts *written off* by way of depreciation prior to 1st July, 1948, although it would appear to apply to sums *retained*, but not written off, prior to that date, *e.g.*, it would seem that an amount credited to a depreciation fund account prior to 1st July, 1948, in excess of the amount considered reasonably necessary, should be treated as a reserve.

There should be shown under the heading 'capital reserves' any reserves which for statutory reasons (*e.g.*, a Share Premium Account, or a Capital Redemption Reserve Fund) or because of the provisions of the memorandum or articles of the company, or for other legal reasons (*e.g.*, an unrealised capital profit) are not free for distribution through the profit and loss account. Capital reserves may also include reserves which, although legally distributable are regarded by the directors as not available for distribution at the date of the balance sheet (*e.g.*, a Fixed Asset Replacement Reserve) Such a reserve shown as a capital reserve in one balance sheet may, owing to a change of circumstances, properly be shown as a revenue reserve in the next balance sheet.

A 'revenue reserve' is any reserve other than a capital reserve. By implication, therefore, revenue reserves are those which are available for distribution, and include any unappropriated balance on profit and loss account itself. The Council of the Institute of Chartered Accountants recommend that where revenue reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the sub-division of such reserves under a variety of headings is unnecessary.

(c) Contents of the Profit and Loss Account

By the Eighth Schedule, Part I, there must be shown in the Profit and Loss Account:

(1) (*a*) †The amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets;

(*b*) the amount of the interest on the company's debentures and other fixed loans;

(*c*) the amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practicable between income tax and other taxation;

(*d*) the amounts respectively provided for redemption of share capital and for redemption of loans;

(*e*) †the amount, if material, set aside or proposed to be set aside, to, or withdrawn from, reserves;

(*f*) †the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof. (The Board of Trade may direct that a company shall not be obliged to show an amount so set aside to provisions if the Board is satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact);

(*g*) the amount of income from investments, distinguishing between trade investments and other investments;

(*h*) *the aggregate amount of the dividends paid and proposed.

(2) *If the remuneration of the auditors is not fixed by the company in general meeting, the amount thereof must be shown under a separate heading; for this purpose any sums paid by the company in respect of the auditors' expenses shall be deemed to be included in the expression 'remuneration.'

(3) The following matters must be stated by way of note, if not otherwise shown:

(*a*) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.

(*b*) The basis on which the charge for United Kingdom income tax is computed.

(*c*) *Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.

(*d*) *Except in the case of the first Profit and Loss Account laid before the company after 30th June, 1948, the corresponding amounts for the immediately preceding financial year for all items shown in the Profit and Loss Account.

(*e*) Any material respects in which any items shown in the Profit and Loss Account are affected:

(i) by transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(ii) by any change in the basis of accounting.

*Banking, discount and assurance companies are exempted from the above requirements except those marked with an asterisk (8th Sch., Pt. III; *see* § 15 (*i*) *post*).

†The Board of Trade may, in the national interest, exempt classes of companies from these requirements (8th Sch., Pt. III).

(d) Payments to Directors

By § 196, in any accounts laid before a general meeting, or in a statement annexed thereto, there must be shewn, so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned:

(*a*) the aggregate amount of the directors' emoluments;

(*b*) the aggregate amount of directors' and past directors' pensions; and

(*c*) the aggregate amount of directors' or past directors' compensation for loss of office.

The amounts to be shown must include all relevant sums paid by or receivable from:

(i) the company; and

(ii) the company's subsidiaries; and

(iii) any other person;

except sums to be accounted for to the company or any of its subsidiaries, or undisclosed compensation for loss of office, etc., for which Section 193 requires the director(s) to account to the vendors of shares (see p. 277).

Where necessary, the directors may apportion any payments between the matters in respect of which they have been paid or are receivable in such manner as they think appropriate.

The amount to be shown under (*a*) must include any emoluments paid to or receivable by any person in respect of his services as director of the company, or in respect of his services, *while a director of the company*, as director of any subsidiary company (or of any company of which he was a director on the nomination of the principal company while a director of the latter) or otherwise in connection with the management of the affairs of the company or any subsidiary thereof, and must distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments. (It will be observed that payments by subsidiary companies to their directors need only be included in the directors' emoluments disclosed in the holding company's accounts to the extent that they are made to persons who are also directors of the holding company.)

'Emoluments' include fees and percentages, any sums paid by way of expense allowances in so far as chargeable to U.K. income tax (*i.e.*, expenses which are not allowed as deductions from emoluments under Rule 9, Schedule E, or which are disregarded under Section 164, Income Tax Act, 1952), any contribution paid in respect of a director under any pension scheme and the estimated money value of any other benefits received by him otherwise than in cash.

The amount in (*b*) is not to include any pension paid or receivable under a pension scheme if the scheme is such that the contributions are substantially adequate for the maintenance of the scheme. Otherwise it must include any pension in respect of services of a director or past director of the company, whether paid to or receivable by him or on his nomination, or, by virtue of dependence on or other connection with him, paid to or receivable by any other person. The amount must distinguish

between pensions in respect of services as a director and other pensions. 'Pension' does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

In (*a*) and (*b*) the references to subsidiary companies are to those subsidiaries which were such when the services were rendered.

The amount to be shown under (*c*) must include compensation for loss of office as a director, or for loss of any other office while a director, or on ceasing to be a director either of the company or its subsidiary. It must also include sums paid in consideration of retirement from office. The amount must distinguish between compensation in respect of the office of a director and of other offices and between amounts paid by or receivable from the company, its subsidiaries, and other persons.

It is pointed out that the payment to a *director* of compensation for loss of office is illegal unless previously disclosed to the members and approved by the company (§§ 191 and 192). Where in connection with the transfer of any shares in a company, resulting from:

(*a*) an offer to the general body of shareholders; or

(*b*) any offer made by another body corporate with a view to the company becoming its subsidiary; or

(*c*) an offer by an individual with a view to his being able to control not less than one-third of the voting power of the company; or

(*d*) any other offer which is conditional on acceptance to a given extent;

a payment is to be made to a director as compensation for loss of or retirement from office, he must take all reasonable steps to see that particulars of the payment are sent to the shareholders with the offer for their shares. If these requirements are not complied with, or the making of the proposed payment is not first approved by a meeting called for that purpose of the holders of the class of shares affected, any sum received by the director shall be deemed to have been received by him in trust for any persons who have sold their shares as a result of the offer (§ 193).

The provisions of §§ 191, 192 and 193, as set out above, do not, however, apply to a *bona fide* payment to a director by way of damages for breach of contract, or by way of pension, superannuation allowance, superannuation gratuity or similar payment in respect of past services (§ 194).

The amounts to be shown for any financial year in respect of payments to directors are the sums receivable in respect of that year, whenever paid, or, if the sums are not paid in respect of any period, the sums paid during that year. If, however, sums are not shown in the accounts for the relevant financial year because they represent amounts to be accounted for to the company, its subsidiaries or past or present members of the company by virtue of §193, but the liability is released or not enforced within 2 years, they must be shown separately in the first accounts in which it is practicable to show them, or in a statement annexed to such accounts. The same applies to expenses allowances charged to United Kingdom income tax after the end of the financial year.

If the accounts do not comply with these provisions, the auditors must include in their report, so far as they are reasonably able to do so, a statement giving the required particulars (§196).

Every director of the company and every person who has been an officer of the company within the preceding 5 years, must give notice to the company of the requisite particulars relating to himself (§ 198).

After 30th June, 1948, it is illegal to pay directors' remuneration (whether as director or otherwise) 'free of tax' or in any way varying with rates of tax, unless it is payable under a contract which was in force on 18th July, 1945, providing expressly, and not by reference to the articles, for such payment. Any provision for payment free of tax, otherwise than under a contract as mentioned, is regarded as providing for a payment, as a gross sum subject to income tax and surtax, of the net sum provided (§ 189).

(e) Contents of the Balance Sheet

By the Eighth Schedule, Part I, the following information must be given in the Balance Sheet:

(1) *The authorised share capital, issued share capital, liabilities and assets must be summarised, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there must be specified:

(*a*) any part of the issued capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares;

(*b*) so far as the information is not given in the Profit and Loss Account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid;

(*c*) the amount of the Share Premium Account;

(*d*) particulars of any redeemed debentures which the company has power to re-issue.

(2) *There must be stated under separate headings, so far as they are not written off:

(*a*) the preliminary expenses;

(*b*) any expenses incurred in connection with any issue of share capital or debentures;

(*c*) any sums paid by way of commission in respect of any shares or debentures;

(*d*) any sums allowed by way of discount in respect of any debentures; and

(*e*) the amount of the discount allowed on any issue of shares at a discount.

(3) *The reserves, provisions, liabilities and fixed and current assets must be classified under headings appropriate to the company's business;

Provided that:

(*a*) where the amount of any class is not material, it may be included under the same heading as some other class; and

(*b*) where any assets of one class are not separable from assets of another class, those assets may be included under the same heading.

(4) *Fixed assets must also be distinguished from current assets.

(5) *The method or methods used to arrive at the amount of the fixed assets under each heading must be stated.

(6) The method of arriving at the amount of any fixed assets must, subject to (7) below, be to take the difference between:

(*a*) its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and

(*b*) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value;

and for this purpose the net amount at which any assets stand in the company's books at 1st July, 1948 (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before 1st July, 1948, cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at that date and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets.

(7) The above paragraph (6) does not apply:

(*a*) to assets for which the figures relating to the period beginning with the 1st July, 1948, cannot be obtained without unreasonable expense or delay; or

(*b*) to assets the replacement of which is provided for wholly or partly:

(i) by making provision for renewals and charging the cost of replacement against the provision so made; or

(ii) by charging the cost of replacement direct to revenue; or

(*c*) to any investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note; or

(*d*) to goodwill, patents or trade marks.

The Board of Trade, in the National interest, may exempt classes of companies from certain of these requirements (8th Schedule, Part III).

(8) For the assets under each heading whose amount is arrived at in accordance with paragraph (6) above, there must be shown:

(*a*) the aggregate of the amounts referred to in (6) (*a*); and

(*b*) the aggregate of the amounts referred to in (6) (*b*).

(9) As respects the assets under each heading whose amount is not arrived at in accordance with (6) above because their replacement is provided for as mentioned in (7) (*b*) above, there shall be stated:

(*a*) the means by which their replacement is provided for; and

(*b*) the aggregate amount of the provision (if any) made for renewals and not used.

(10) The aggregate amounts respectively of capital reserves, revenue reserves and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings;

Provided that:

(*a*) a separate statement is not required of any of the said three amounts which is not material; and

(*b*) the Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact.

(11) There must also be shown (unless it is shown in the Profit and Loss Account or a statement or report annexed thereto, or the amount involved is not material):

(*a*) where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and

(*b*) where:

(i) the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or

(ii) the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof;

the application of the amounts derived from the difference.

Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, these requirements apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof.

(12) (i) There must be shown under separate headings:

(*a*) *†the aggregate amounts respectively of the company's trade investments, quoted investments other than trade investments and unquoted investments other than trade investments;

(*b*) *if the amount of the goodwill and of any patents and trade marks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is so shown or ascertainable and as so shown or ascertained, as the case may be;

(*c*) *the aggregate amount of any outstanding loans made under the authority of provisos (*b*) and (*c*) of subsection (1) of section 54;

(*d*) the aggregate amount of bank loans and overdrafts;

(*e*) *the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend.

Nothing in the foregoing is to be taken as requiring the amount of the goodwill, patents and trade marks to be stated otherwise than as a single item.

(ii) †The heading showing the amount of the quoted investments other than trade investments must be sub-divided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognised stock exchange.

(13) *Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the fact that that liability is so secured must be stated, but it is not necessary to specify the assets on which the liability is secured.

(14) *Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company must be stated.

(15) *The following matters must be stated by way of note, or in a statement or report annexed, if not otherwise shown:

(i) The number, description and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say:
  (*a*) the period during which it is exercisable;
  (*b*) the price to be paid for shares subscribed for under it.

(ii) The amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated before deduction of income tax, except that, in the case of tax free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated.

(iii) †Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured.

(iv) †The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

(v) †Where practicable the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.

(vi) †If in the opinion of the directors any of the current assets have not a value, on realisation in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion.

(vii) The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the stock exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their stock exchange value.

(viii) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.

(ix) †The basis on which the amount, if any, set aside for United Kingdom income tax is computed.

(x) Except in the case of the first Balance Sheet laid before the company after 30th June, 1948, the corresponding amounts at the end of the immediately preceding financial year for all items shown in the Balance Sheet

*Banking and Discount companies must comply with these paragraphs (except (15) (vii)); they need not comply with the other requirements.

†Assurance companies are exempt from the requirements so marked, otherwise they must comply with the requirements marked with an asterisk, but not others.

Where the company is a holding company there must be shown separately in the Balance Sheet:

(*a*) the aggregate of shares in subsidiaries;
(*b*) the aggregate of indebtedness of subsidiaries to the company;
(*c*) the aggregate of indebtedness of the company to subsidiaries.

There must also be a note on the Balance Sheet, or in a statement or report annexed thereto, of the number, description and amount of the shares in and debentures of the company, held by its subsidiaries or their nominees.

The special provisions of the Act relating to the accounts of holding companies are set out and fully considered in Chapter IX.

(f) Fixed Assets

While the Act requires fixed assets to be distinguished from current assets, the Board of Trade have intimated that no objection will be taken to an asset not being described as 'fixed' or 'current' if to do so would not be a true and fair description, provided the nature of the asset is stated clearly.

The normal method of arriving at the amount of any fixed asset is to take the difference between:

(*a*) its cost or, if it stands in the company's books at a valuation, the amount of that valuation, and
(*b*) the aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value.

For assets under each heading, the aggregate of (*a*) and the aggregate of (*b*) must each be stated.

Where, however, the records do not enable the normal basis to be used, and the figures relating to the period before 1st July, 1948, cannot be obtained without unreasonable expense or delay the net amount at which the assets stood in the company's books at 1st July, 1948 (after deducting the amounts previously provided or written off for depreciation or diminution in value), is to be regarded as a valuation of the assets made on that day. This is referred to as 'the net book amount basis'. In such cases, there are likely to be two groups of assets, one to which the normal basis can be applied and one for which the net book amount basis has to be used.

Care must be taken that a true and fair view of the assets is disclosed. The Act is satisfied if, under an asset heading with appropriate wording one aggregate figure is shewn embodying both cost and valuation (including net book amount where this has to be treated as a valuation) with one aggregate deduction for depreciation.

In recommendations made by the Council of the Institute of Chartered Accountants the following alternative methods of disclosure, which have been approved by counsel, as complying with the Act, are made:

SUGGESTION A

	£	£
PLANT AND MACHINERY		
At Cost* (and, where figures for cost *or valuation* are not reasonably obtainable, at the net amount standing in the company's books on 1st July, 1948, less sales)	825,000	
Less: Depreciation	225,000	
		£600,000

*Or 'independent valuation in 19...,' or 'partly cost and partly independent valuation in 19...,' according to the circumstances.

SUGGESTION B

(Adapting A to circumstances where several fixed assets can be grouped conveniently under the same heading.)

	Cost, etc.	Depreciation	Net
FREEHOLD AND LEASEHOLD LAND AND BUILDINGS, PLANT, MACHINERY AND EQUIPMENT			
At Cost* (and, where figures for cost *or valuation* are not reasonably obtainable, at the net amount standing in the company's books on 1st July, 1948, less sales) less depreciation:			
Freehold land and buildings	225,000	25,000	200,000
Leasehold land and buildings	85,000	10,000	75,000
Plant, machinery and equipment	825,000	225,000	600,000
	£1,135,000	£260,000	£875,000

*As in 'A' above.

SUGGESTION C

(Distinguishing the totals for items dealt with on the normal basis and items dealt with on the net book amount basis.)

	Cost, etc.	Depreciation	
PLANT AND MACHINERY	£	£	£
At Cost* less depreciation	650,000	200,000	
At the net amount standing in the company's books on 1st July, 1948 (where figures for cost *or valuation* are not reasonably obtainable), less sales and depreciation	175,000	25,000	
	£825,000	£225,000	£600,000

*As in 'A' above.

SUGGESTION D

(A variant of Suggestion C)

The following alternative arrangement, giving the same information and again showing the two aggregates referred to under suggestion C, might facilitate the insertion of comparative figures:

PLANT AND MACHINERY	£		£
(*a*) At Cost*	650,000		
(*b*) At the net amount standing in the company's books on 1st July, 1948, where figures for cost *or valuation* are not reasonably obtainable, less sales	175,000		
		825,000	
Deduct depreciation on amounts stated at:			
(*a*) above	200,000		
(*b*) above	25,000		
		225,000	
			£600,000

*As in 'A' above.

The division of the totals between normal basis and net book amount basis (suggestion C or D) will usually give a fairer view of the assets than is the case where one total only is shown and it approaches nearest to the intention behind the requirement to show cost less accumulated provisions.

It may be considered desirable for purposes of clarity and to enable the Balance Sheet to be read easily (particularly as the comparative figures for the previous year must be given) to show in the main part of the Balance Sheet an abbreviated description thus:

PLANT AND MACHINERY
Per Schedule £600,000

the details, under whichever method of presentation is adopted, being shown in the schedule.

(g) Loans to Officers

By § 197 the accounts which are required by the Act to be laid before the company in general meeting must also contain particulars showing:

(*a*) the amount of any loans made during the company's financial year to:
- (i) any officer of the company; or
- (ii) any person who, after the making of the loan, became during that year an officer of the company;

by the company or a subsidiary thereof (*i.e.*, a company which was a subsidiary at the end of the company's financial year (whether or not a subsidiary at the date of the loan)) or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and

(*b*) the amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof.

The foregoing does not, however, require the inclusion in accounts of particulars of:

(*a*) a loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or

(*b*) a loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed £2,000 and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice adopted or about to be adopted by the company or subsidiary with respect to loans to its employees;

not being, in either case, a loan made by the company under a guarantee from or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.

If, in the case of any such accounts as aforesaid, the requirements of this section are not complied with, it is the duty of the auditors of the company by whom the accounts are examined to include in their report on the Balance Sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

By § 455, the expression 'officer' (unless the context requires otherwise) includes a director, manager or secretary.

By § 190, it is illegal for a company (other than an exempt private company) to make a loan to a person who is its director or a director of its holding company, or to give a guarantee or security for such a loan.

This does not, however, apply:

(*a*) to anything done by a subsidiary, where the director is its holding company; or

(*b*) to funds provided to enable a director properly to perform his duties as an officer of the company; or

(*c*) in the case of a company whose ordinary business includes the lending of money, to anything done by the company in the ordinary course of business.

Exception (*b*) only applies where the loan is first approved by the company at a general meeting at which the purposes of the expenditure and the amount of the loan are disclosed; or on condition that, if the approval of the company is not given at or before the next following annual general meeting, the loan shall be repaid within six months from the conclusion of that meeting. Where the approval of the company is not given, the directors authorising the loan will be jointly and severally liable to indemnify the company against any loss arising therefrom.

Under Section 155, the Balance Sheet must be signed on behalf of the board by two of the directors, or if there is only one, by that director.

In the case of a banking company registered after 15th August, 1879, the Balance Sheet must be signed by the secretary or manager, if any, and where there are more than three directors of the company, by at least three of those directors, and where there are not more than three directors by all the directors.

The Profit and Loss Account, and, so far as not incorporated in the Balance Sheet or Profit and Loss Account, any group accounts laid before the company in general meeting, shall be annexed to the Balance Sheet, and the auditor's report shall be attached thereto.

Any accounts so annexed shall be approved by the board of directors before the Balance Sheet is signed on their behalf (§ 156).

(h) The Director's Report

There must be attached to every Balance Sheet laid before a company in general meeting a report by the directors with respect to the state of the company's affairs, the amount, if any, which they recommend should be paid by way of dividend, and the amount, if any, which they propose to carry to reserves.

The report must deal, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the directors' opinion be harmful to the business of the company or of any of its subsidiaries, with any change during the financial year in the nature of the company's business, or in the company's subsidiaries, or in the classes of business in which the company has an interest, whether as member of another company or otherwise (§ 157).

(i) Exceptions for Special Classes of Companies (Eighth Schedule, Part III)

1. A banking or discount company (*i.e.*, any company which satisfies the Board of Trade that it ought to be treated for those purposes as a banking company or a discount company) is not required to comply with the provisions of Part I of the Eighth Schedule, except:

(*a*) as regards the Balance Sheet, those listed on pp. 278-82 under paragraphs 1, 2, 3, 4 and 5 (so far as relates to fixed and current assets), 12 (except 12 (*d*)), 13, 14 and 15 (except 15 (vii)); and

(*b*) as respects its Profit and Loss Account, those shewn on p. 275 under paragraphs 1 (h), 2 and 3 (c) and (d);

but where in its Balance Sheet capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact, and its Profit and Loss Account shall indicate by appropriate words the manner in which the amount stated for the company's profit or loss has been arrived at.

The accounts of a banking or discount company are not to be deemed, by reason only of the fact that they do not comply with any requirements of Part I of the 8th Schedule from which the company is exempt by virtue of the above, not to give the true and fair view required by the Act.

2. In relation to an assurance company within the meaning of the Insurance Companies Act, 1958, which is subject to and complies with the requirements of that Act as respects the preparation and deposit with the Board of Trade of a Balance Sheet and Profit and Loss Account, the foregoing paragraph shall apply as it applies in relation to a banking or discount company, and such an assurance company shall also not be subject to the requirements set out in paragraphs 12 (i) (*a*) and 12 (ii), (15) (iii), (iv), (v), (vi) and (ix) on pp. 280-3.

The Board of Trade may, however, direct that any such assurance company whose business includes to a substantial extent business other than assurance business shall

comply with all the requirements of the said Part I or such of them as may be specified in the direction and shall comply therewith as respects either the whole of its business or such part thereof as may be so specified.

Where an assurance company is entitled to the benefit of the above paragraph, then any wholly owned subsidiary thereof shall also be so entitled if its business consists only of business which is complementary to assurance business of the classes carried on by the assurance company. For this purpose a company shall be deemed to be the wholly owned subsidiary of an assurance company if it has no members except the assurance company and the assurance company's wholly owned subsidiaries and its or their nominees.

3. (i) A company of any class prescribed for the purposes by the Board of Trade, where it considers it desirable in the national interest will not be subject to the following requirements of the Schedule:

(*a*) as respects its Balance Sheet, those set out on pp. 278-80 under paragraphs (3) (4) and (5) (except so far as the said paragraphs relate to fixed and current assets) ; and paragraphs (6) (7) (8) (9) (10) and (11); and

(*b*) as respects its Profit and Loss Account, those set out on p. 275 under paragraphs (1) (*a*) (*e*) and (*f*);

but a company taking advantage of this exemption is subject to any prescribed conditions as respects matters to be stated in its accounts or by way of note thereto and as respects information to be furnished to the Board of Trade or a person authorised by them to require it.

(ii) The accounts of a company shall not be deemed, by reason only of the fact that they do not comply with any requirements of Part I of the Schedule from which the company is so exempted, not to give the true and fair view required by the Act.

If the Board of Trade are satisfied that any of the conditions prescribed has not been complied with in the case of any company, they may direct that so long as the direction continues in force the exemption shall not apply to the company.

4. Where a company entitled to the benefit of any provision contained in Part III of the Schedule is a holding company, the reference in Part II of the Schedule to consolidated accounts complying with the requirements of the Act shall, in relation to consolidated accounts of that company, be construed as referring to those requirements in so far only as they apply to the separate accounts of that company.

(j) Presentation of Balance Sheet and Profit and Loss Account

Whilst the form in which accounts are submitted to shareholders is (subject to compliance with the Companies Act) a matter within the discretion of directors, the following recommendations, made in October 1958 by the Council of the Institute of Chartered Accountants in England and Wales, are designed to indicate what is regarded as the best practice.

Balance Sheet

Headings for groups of items

The terms used in paragraphs 2, 3 and 4, of the Eighth Schedule to the Companies Act 1948, such as issued share capital, reserves, liabilities, fixed assets and current assets, are normally

appropriate headings for summaries and classifications. Other headings should be used if it is considered that they will be better for the purpose of presenting a true and fair view of the state of affairs of the company. The use of general main headings such as 'Liabilities' and 'Assets' is unnecessary.

Redeemable preference shares
In addition to the earliest date on which the company has power to redeem redeemable preference shares, other material facts relating to redemption of those shares should be indicated; examples are the latest date on which redemption may take place and any premium payable on redemption.

Reserve fund
The description 'reserve fund' should not be applied to a reserve unless it is represented by specifically earmarked investments (or other assets) realizable as and when required at not less than the amount of the 'reserve fund'. Exceptions arise from the statutory requirement to describe a 'capital redemption reserve fund' as such and from any provision of the memorandum or articles of association, or other instrument constituting or regulating a company, requiring a reserve to be described as a 'fund'.

Capital reserves
The expression 'capital reserves' should be used to describe reserves which for statutory reasons or because of the provisions of the memorandum or articles of a company or for other legal reasons are not free for distribution through the profit and loss account.

The expression 'capital reserves' may also be applied to other reserves which although legally distributable, are regarded by the directors as not available for distribution at the date of the balance sheet. Such a reserve shown as a capital reserve in one balance sheet may, owing to a change of circumstances, properly be shown in the next balance sheet as a revenue reserve.

Sub-division of revenue reserves (including unappropriated profits)
Where revenue reserves are retentions of distributable profits available for general use in the business and none of them is created in accordance with statutory requirements or in pursuance of any obligation or policy, the sub-division of such reserves under a variety of headings is unnecessary.

Additions to and withdrawals from reserves
All profits and losses of a revenue nature should normally be reflected in the profit and loss account. Additions to or utilizations of revenue reserves and the application of capital reserves to the relief of charges on revenue should therefore normally be passed through that account. They should be dealt with either as items entering into the ascertainment of the results shown for the year or as adjustments of the unappropriated balance from the accounts of the current and prior years as may be appropriate. This does not, however, prevent wholly exceptional items of material amount which do not relate to the accounting period from being taken direct to reserves if a true and fair view will be better presented in that way.

If the inclusion in the profit and loss account of capital losses and of realized capital profits (so far as these may lawfully be included) will facilitate the presentation of a true and fair view of the results of the transactions of the year they should be passed through that account.

When movements in reserves are not shown in the profit and loss account and are of material amount they should be disclosed in the balance sheet or in notes on the accounts. Such items may include movements on capital reserves not dealt with as mentioned above, transfers between reserves, transfers from reserves to share capital account and applications of reserves in writing-off items such as preliminary and issue expenses.

Sub-total of share capital and reserves

A sub-total of share capital and reserves, including any credit balance carried forward on profit and loss account, should be shown and any description should be factual, such as 'share capital and reserves'. Descriptions such as net worth, which lend themselves to being misunderstood as tending to suggest that a balance sheet purports to be a statement of values, or to show the value of the undertaking, should be avoided.

Adverse balance on profit and loss account

Available reserves should be appropriated to extinguish an adverse balance on profit and loss account. Where this practice is not adopted, the adverse balance should be grouped with and be a deduction in arriving at the sub-total of share capital and reserves. Preferably such deduction should be made first from revenue reserves; if these are insufficient then from the aggregate of revenue and capital reserves. If both are insufficient the adverse balance should be deducted from the aggregate of share capital and reserves.

Amounts set aside for future income tax

Amounts set aside for future income tax, whether described as reserves or not, should be shown separately and should preferably *not* be aggregated with reserves. Income tax assessable for any income tax year commencing after the balance sheet date should not be grouped with liabilities.

Provisions

Where the replacement of fixed assets is dealt with by making provision for renewals and charging the cost of replacement against the provision so made, the accumulated amount of provision for renewals, so far as not used, should be shown separately. Such a provision should not be shown as a deduction from the assets.

Where depreciation is provided on fixed assets, an amount set aside in recognition of the increased cost expected to be incurred in replacing fixed assets, as compared with the amount at which they are carried in the books, is not a 'provision'; it is a reserve and should be shown as such.

On a proper grouping of the balance sheet some provisions may not be suitable for aggregation with other provisions; for example, where some provisions are current liabilities and others are not. The statutory requirement (paragraph 6 of the Eighth Schedule) to give an 'aggregate' should not be treated as a restriction operating against the presentation of a true and fair view.

Reasonableness of provisions

Paragraph 27 (2) of the Eighth Schedule provides that where any amount written off or retained by way of providing for depreciation, renewals, or diminution in value of assets, or retained by way of providing for any known liability, is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not as a provision. Directors should be advised that an opinion expressed in accordance with paragraph 27 (2) should be based on a consideration of all relevant information and have regard to recognised accounting principles.

Grouping of liabilities and proposed dividends

Current liabilities and proposed dividends should normally be shown in one group classified under appropriate descriptions and will include *inter alia:*

(*a*) trade liabilities, bills payable, accrued charges;
(*b*) short-term loans;
(*c*) bank loans and overdraft;
(*d*) current taxation;
(*e*) provision for any current liability of which the amount cannot be determined with substantial accuracy;

(*f*) proposed dividends (less income tax).

In respect of all liabilities other than current liabilities, a specific description, such as debenture stock, mortgages, or unsecured notes, should be given. The dates and material conditions of redemption or conversion should be indicated.

Secured liabilities

Paragraph 9 of the Eighth Schedule provides that where any liability is secured otherwise than by operation of law on any assets of the company, the fact that the liability is so secured shall be stated. In complying with this paragraph the word 'secured' should not be used without amplification if there is evidence from the documents that the charge on the assets is for an amount less than the liability.

Bank overdrafts

To comply with paragraph 8 (1) (*d*) of the Eighth Schedule the aggregate amount of bank loans and overdrafts must be shown under a separate heading. Where there are debit and credit bank balances with no legal right of set-off the full amounts of bank loans and overdrafts and of bank balances should be shown.

Contingent liabilities

Where some contingent liabilities are not suitable for aggregation with others the amount or estimated amount of each contingent liability or group of contingent liabilities should be shown if practicable.

Future capital expenditure

In a statement of the aggregate amount or estimated amount of contracts for capital expenditure, given to comply with paragraph 11 (6) of the Eighth Schedule, the description 'contracts for capital expenditure' is appropriate and, as a description of this item, is preferable to 'commitments for capital expenditure' which may have a wider significance.

Where a company has entered into contracts for only part of the work on a project of capital expenditure a matter which directors might be recommended to consider is whether, in addition to stating the amount of contracts outstanding, further information might usefully be given indicating the estimated total expenditure involved in the project they have approved.

Other forward contracts

The existence of uncompleted or forward contracts for the purchase and sale of goods or services in the ordinary course of business is not generally referred to in the balance sheet, but consideration should be given to the possibility of losses arising from open positions on forward contracts and the necessity for providing for such losses.

Assets

Paragraph 4 (2) of the Eighth Schedule requires that fixed assets shall be distinguished from current assets. The division of assets into either 'fixed' or 'current' is not always practicable and could be misleading. (This is sometimes the case with interests in subsidiaries.) Where neither 'fixed' nor 'current' is a true and fair description, the assets should not be described as either but the nature of the assets should be stated clearly.

Where an asset is classified as neither fixed nor current the method of arriving at and stating the amount of a fixed asset, set out in paragraph 4 (3) and (except in the case of interests in subsidiaries) paragraph 5 of the Eighth Schedule, should be applied.

Fixed assets

The fundamental characteristic of fixed assets is that they are held with the object of earning revenue, directly or indirectly, and not for the purpose of sale in the ordinary course of business. They will normally include such assets as:

(*a*) goodwill, patents and trade-marks;

(*b*) freehold land and buildings;

(*c*) Leaseholds;

(*d*) plant, machinery and equipment;

(*e*) investments intended to be held continuously by the business.

Interests in subsidiaries

Interests in subsidiaries, which may consist of shares in subsidiaries and amounts owing by subsidiaries in respect of debentures or otherwise, should generally be shown as one group in the balance sheet of the holding company. It may, however, be desirable to group with current assets the aggregate of the temporary advances and/or the amounts due on current accounts which are regularly paid, provided it is possible to segregate the whole of such amounts from other indebtedness of the subsidiaries to the holding company.

A holding company's indebtedness to its subsidiaries should normally be grouped with liabilities but should be stated separately. Such indebtedness may, however, be shown as a deduction from interests in subsidiaries in appropriate circumstances, for example where the subsidiaries lend their surplus funds to the holding company.

Fellow subsidiaries

Shares held by a subsidiary in a fellow subsidiary should be shown separately.

Associated companies

Where interests in associated companies are material they should be stated separately under the general heading of 'Trade Investments' or under a heading of their own.

Current assets

Items classified as current assets should include:

(*a*) stock-in-trade and work in progress;

(*b*) trade and other debtors, bills receivable and prepayments (other than those on capital expenditure or of a long-term nature);

(*c*) quoted and other realizable investments (other than trade investments, investments in subsidiaries and fellow subsidiaries and other investments intended to be held continuously even though they may happen to be quoted or otherwise readily realizable);

(*d*) tax reserve certificates;

(*e*) bank balances and cash.

Overseas assets

If there are material amounts of assets in overseas countries where restrictions on remittances are in force this fact should be disclosed and there should be given such other information, if any, as may be needed to give a true and fair view.

Investments

(*a*) *Classification*

Investments which it is intended to hold continuously, *e.g.*, trade investments and interests in subsidiaries, should be classified as *fixed assets*.

Investments which are fixed assets may be distinguished from other fixed assets by showing them under a separate heading.

Where interests in associated companies are material they should be stated separately under the general heading of 'Trade Investments' or under a heading of their own.

'Trade investments' comprise:

(*a*) investments acquired and held primarily in order to protect the company's goodwill, or to facilitate or further its own existing business, rather than for income or appreciation in value;

(*b*) investments representing a substantial but not a controlling interest in another company, particularly where the company has the right to appoint its own representatives to take part in the arrangement. Such holdings are often referred to as 'Investments in associated companies'.

Quoted and other readily realizable investments (other than trade investments, investments in subsidiaries and fellow subsidiaries, and other investments intended to be held continuously, even though they happen to be quoted or are otherwise readily realizable), should be classified as *current assets.*

When calculating the market value of a quoted investment by reference to a stock exchange quotation, it is usual to use the mean of the two quotations shown in the *Stock Exchange Official List*. If any other basis is used it may be desirable to indicate its nature.

Special considerations applicable to holding companies

Interests in subsidiaries, which may consist of shares in subsidiaries and amounts owing by subsidiaries in respect of debentures or otherwise, should generally be shown as one group in the balance sheet of the holding company. It may, however, be desirable to group with current assets the aggregate of the temporary advances and/or amounts due on current accounts which are regularly paid, provided it is possible to segregate the whole of such amounts from other indebtedness of the subsidiaries to the holding company.

A holding company's indebtedness to its subsidiaries should normally be grouped with liabilities, but should be stated separately. Such indebtedness may, however, be shown as a deduction from interests in subsidiaries in appropriate circumstances, *e.g.*, where the subsidiaries lend their surplus funds to the holding company.

(*b*) *Valuation*

Investments should normally be stated in the balance sheet at cost, subject to any necessary provision for diminution in value.

Provision should be made for diminution in value of investments:

(i) where the market value at the date of the balance sheet of investments treated as current assets is lower than cost; and

(ii) where the value of investments treated as fixed assets appears to have decreased permanently below cost.

Where an undertaking in which an important trade investment is held has retained and accumulated profits on such a scale that the income from the investment and the amount at which it appears in the balance sheet provide a wholly inadequate value of the investment, it may be necessary to give some explanation in the accounts to ensure that they show a fair view.

In regard to interests in subsidiaries the requirements of paragraph 4 (3) of the Eighth Schedule to state the methods used to arrive at the amounts at which the fixed assets are stated should be complied with. This applies whether such interests are grouped with fixed assets or shown as a separate group; it does not apply to any part of such interests grouped with current assets.

Where a *sinking fund policy* is shown in the balance sheet otherwise than at surrender value the surrender value should be shown by a note.

Treasury bills should be shown as current assets and should be stated at cost or at their face value discounted at the market rate.

Profit and Loss Account

Profit or loss of the year

Where the turnover is not disclosed the profit and loss account should commence with the trading surplus or deficit of the year computed *after* charging depreciation and all other trading expenses. Depreciation and other items which have been charged or brought to credit

in arriving at the trading surplus or deficit, but which are disclosed to comply with the *Companies Act, 1948*, or because the directors consider that they should be disclosed, should be shown by notes on the account or by an unextended inset or in a 'box' immediately after the trading surplus or deficit of the year.

Other income and non-trading expenditure of the year should then be shown. If the balance on the account at this stage shows a profit it may be described as 'profit before taxation' and against this amount there should be charged the taxation based on this profit. The balance arrived at is the 'profit after taxation'.

Items of an exceptional or non-recurrent nature should be dealt with in such a way as to show in the particular circumstances a true and fair view of the results of the year. Such items, other than tax adjustments of earlier years, may be dealt with as follows:

(*a*) where the items arise from the trading operations of the company, they may be dealt with in arriving at the trading surplus or deficit and disclosed separately;

(*b*) they may be shown separately in the section of the account which includes other income and non-trading expenditure of the year;

(*c*) they may be shown separately after the 'profit after taxation';

(*d*) they may in appropriate circumstances be omitted from the profit and loss account and taken direct to reserve.

Where exceptional or non-recurrent items have been taken into account before arriving at 'profit before taxation', any tax charges or relief arising because of the items should be included with the tax charge on such profit.

Where exceptional or non-current items are not taken into account before arriving at 'profit before taxation', the effect of these items on the account shown in respect of tax should be considered; where appropriate the relevant tax charges or reliefs should be shown as separate adjustments to the respective items.

Whether brought into the account with the tax charge of the year or shown after 'profit after taxation' any adjustment of the tax charge of previous years should be separately disclosed, if material.

Depreciation of fixed assets

The requirements in paragraph 14 (2) of the Eighth Schedule should be applied to each class of fixed assets and not to fixed assets as a whole: this requirement is that, if depreciation or replacement of fixed assets is provided for by some method other than depreciation charge or provision for renewals, or is not provided for, the profit and loss account must state the method by which it is provided for or the fact that it is not provided for, as the case may be.

Annual payments

Debenture, loan and note interest, royalties and other annual charges payable under deduction of income tax should be charged gross in the profit and loss account.

Income from investments

Dividends, interest and other income should be brought to credit gross and should therefore include income tax suffered by deduction, or deemed for income tax purposes to have been suffered by deduction, on such income. The relative amount of income tax should be included as part of the charge for income tax for the year.

Income from subsidiaries

Although paragraph 12 (1) (*g*) of the Eighth Schedule requires the amount of income from investment to be shown, paragraph 15 (2) (*a*) excludes income from investments in subsidiaries from this requirement. Income (gross) from subsidiaries may, with appropriate narrative, properly be included in the trading surplus of the holding company and need not be shown separately in the profit and loss account of that company unless it is necessary to do so in order to present a true and fair view.

Subvention payments

A subvention payment (Section 20 of the *Finance Act, 1953*) made by a holding company to a subsidiary can for accounting purposes be regarded as the converse of the receipt of a dividend from a subsidiary. Therefore:

(*a*) where a holding company has given or received a subvention payment it need not be shown separately in the profit and loss account of the holding company provided that the income from investments in subsidiaries is included in the trading result and there is appropriate description of that result;

(*b*) a subvention payment should normally be shown separately in the profit and loss account of a subsidiary which has received or given a subvention from or to the holding company or a fellow subsidiary. This disclosure may, however, properly be omitted where trading results have been affected materially by an arbitrary course of dealing in respect of inter-company transactions.

Dividends paid and proposed

In addition to the statutory requirement that the aggregate amount of dividends paid or proposed shall be shown in the profit and loss account, the dividends on each class of shares should be shown, distinguishing between dividends already paid and dividends recommended. The rates (per cent or per share) at which dividends have been declared or are proposed should preferably be stated. It may be helpful to shareholders to state the dates of the payment of the dividends.

The amounts shown in respect of dividends should be the net amounts, whether they are declared as 'subject to income tax', 'less income tax' or 'free of income tax'.

Comparative figures

Where an item appears in a note on the accounts or in a document annexed thereto the corresponding amount for the immediately preceding year should be shown.

Where the accounts do not include an item corresponding to an item which appeared in the accounts for the preceding year, the amount for that earlier year should nevertheless be shown, except that where the item appeared in a note on or document annexed to the accounts for the immediately preceding year it may not be necessary to repeat the item unless its omission could cause the comparison of the two years' accounts to be misleading.

If items in the accounts have been re-grouped, subdivided or otherwise rearranged as compared with the accounts for the immediately preceding year, then the items for that year should be similarly rearranged for the purpose of showing the comparative figures.

Where a change in the basis of accounting affects materially the comparability of the profit and loss account of the year with that of the preceding year appropriate information should be included in the accounts by way of a note or otherwise. This information should explain the nature of the change and should indicate either the extent to which the account of the preceding year would have been affected had the revised basis been in use in that year, or, as may be appropriate, the extent to which the account of the current year would have been affected had no change been made.

Notes on the accounts

Where a note relates to an item in the accounts there should be a reference against that item to the note.

Where information is given in the director's report instead of in the accounts the relative paragraphs in the directors' report should be clearly identifiable and specially referred to in the accounts.

A copy of the chairman's statement, even if it accompanies the accounts, is not an appropriate document in which to give information which should be given in the accounts.

Illustration

At June 30th, 1958, the books of Veneering Manufacturers, Ltd., a public limited company, showed the following balances:

	£	£
10,000 8% Cumulative Preference Shares (Authorised 10,000) ...		10,000
£40,000 Ordinary Stock (Authorised £50,000)		40,000
Freehold Land and Buildings at cost	22,420	
Plant, Machinery and Tools (cost £24,000)	12,000	
Office Furniture and Fittings (cost £3,000)	2,200	
Goodwill at cost	10,000	
Stock of Raw Materials, July 1st, 1957	9,320	
Stock of Finished Goods, July 1st, 1957	1,270	
Work in Progress do.	920	
Sundry Debtors	10,700	
4% Debenture Stock		15,000
Debenture Interest, half-year to December 31st, 1957 (gross) ...	300	
Shares in Subsidiary Company, 15,000 Ordinary Shares, at cost	18,750	
Tax Reserve Certificates	8,000	
Interest on Tax Reserve Certificates		30
Interest and Dividends on Investments (gross):		
Trade		100
Quoted		300
Dividend on Shares in Subsidiary Company (gross)		3,800
Share Premium Account		3,640
General Reserve		10,000
Trade Investments at cost	3,200	
Quoted Investments at cost (market value as at June 30th, 1958 (£8,680)	8,020	
Profit and Loss Account		3,090
Amount owing to Subsidiary Company		7,680
Cash at Bankers and in Hand	8,597	
Sundry Creditors		7,790
Sales		67,100
Purchases	31,960	
Carriage Inwards	1,890	
Wages and National Insurance	13,790	
Rates	630	
Salesmen's Salaries	800	
Repairs to Premises	60	
Salaries (including Directors' Salaries £3,000)	4,130	
Postages and Telephone	180	
Printing and Stationery	40	
Legal and Professional Charges	80	
Sundry Trade Expenses	50	
Directors' Fees	60	
Bank Charges	10	
Commissions	520	
Power and Lighting	670	
Carried forward ...	£170,567	£168,530

Brought forward ...	£170,567	£168,530
Insurances—Factory ...	720	
Office ...	40	
Repairs to Plant ...	850	
Preference Share Dividend, half-year to December 31st, 1957 (net)	230	
Income Tax Account ...		3,877
	£172,407	£172,407

The debentures are secured by a floating charge on the assets of the company.

Stocks, etc., as at June 30th, 1958, were as follows:

Raw Materials ...	£7,640
Work in Progress ...	1,280
Finished Goods ...	4,010

Accrued charges are to be provided for as under:

Power and Lighting ...	£240
Commissions ...	160
Audit Fee ...	100

A provision of £250 is to be made against doubtful debts.

Unexpired insurances totalled £110 and rates amounting to £240 had been paid for the half-year to September 30th, 1958. Depreciation is to be written off plant, machinery and tools and office furniture and fittings at the rates of 20% and 10% respectively on the book values.

The balance on Income Tax Account is made up as follows:

Amount bought forward for Schedule D liability for 1958-59 ...	£5,535
Tax recouped by deduction from £300 Debenture Interest ...	127
	5,662
Less Tax deducted from Income on Investments ...	1,785
	£3,877

Schedule D income tax payable for 1958-59 was agreed at £5,395. The following estimated liabilities to taxation on the current profits are to be taken into account:—

Income tax ...	£4,980
Profits tax ...	1,650

The directors recommend that, after provision for taxation based on the profits of the year, the dividend for the half-year ended June 30th, 1958, on the preference shares be paid, less tax, and that a dividend of 12½%, less tax, be paid on the ordinary stock.

The company has contracts on hand for the supply of heavy machinery to the value of £8,000, which are not to be provided for in the accounts.

The directors received salaries from the subsidiary company amounting to £1,500 during the year.

Prepare:

1. Manufacturing, Trading and Profit and Loss Account for the year ended June 30th, 1958, for presentation to the Directors; and

2. Profit and Loss Account for the year ended and Balance Sheet as at, 30th June, 1958, in a form suitable for presentation to the members, embodying the requirements of the Companies Act, 1948. Comparative figures and group accounts can be ignored. Income tax to be taken into account at 8s. 6d. in £.

VENEERING MANUFACTURERS, LTD.

Manufacturing, Trading and Profit and Loss Account for the Year ended 30th June, 1958.

(For presentation to the Directors.)

	£	£			£
Materials—			By Cost of Goods Produced, transferred to Trading Account ...		53,730
Stock, 1st July, 1957 ...	9,320				
Purchases	31,960				
Carriage Inwards ...	1,890				
	43,170				
Less Stock 30th June, 1958 ..	7,640				
		35,530			
„ Wages and National Insurance .		13,790			
„ Power and Lighting .	910				
„ Factory Insurance	610				
„ Repairs to Plant	850				
„ Depreciation of Plant, etc. ..	2,400				
		4,770			
		54,090			
By Work in Progress 30th June, 1958	1,280				
Less Work in Progress 1st July, 1957 . ..	920				
		360			
		£53,730			£53,730
To Finished Goods—					
Stock, 1st July, 1957		1,270	By Sales		67,100
Cost of Goods produced		53,730			
		55,000			
Less Stock, 30th June, 1958 ..		4,010			
„ Cost of Sales		50,990			
Gross Profit c/d		16,110			
		£67,100			£67,100
To Establishment—			By Gross Profit b/d.		16,110
Rates	£510				
Repairs to Premises	60				
Insurances	40				
Depreciation of Office Furniture ..	220				
		830			
„ Administration—					
Directors' Emoluments ...	3,060				
Salaries . ..	1,930				
Commissions ...	680				
Audit Fee	100				
Postages and Telephone .. .	180				
Printing and Stationery ..	40				
Legal and Professional Charges	80				
Sundry Trade Expenses	50				
Bank Charges	10				
		6,130			
„ Finance—					
Interest on Debentures	600				
Provision for Doubtful Debts . ..	250				
		850			
„ Net Trading Profit for year c/d.		8,300			
		£16,110			£16,110
To Taxation on profits for year—			By Net Trading Profit for year		8,300
Profits Tax .	£1,650		„ Interest on Tax Reserve Certificates		30
Income Tax .	6,510		„ Dividend from Subsidiary Company		3,800
		8,160	„ Income on Trade Investments		100
			„ Income on Quoted Investments .		300
Balance, being Net Income for year, after Taxation		4,370			
		£12,530			£12,530
To Dividends (*less* tax):					
Paid – 8% Preference, half-year to 31st Dec. 1957	230				
Proposed –					
8% Preference, half-year to 30th June 1958	230		By Net Income for year, after Taxation, b/d. ...		4,370
Ordinary, 12½% for year to 30th June 1958	2,875		„ Balance brought forward from last year ..	£3,090	
		3,335	*Add* Over provision for Income Tax now written back	140	
„ Balance carried forward		4,265			
		£7,600			

VENEERING MANUFACTURERS LTD.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE, 1958.

(For presentation to the Members.)

		£			£
To Provision for Depreciation		2,620	By Net Trading Profit for year, *less* expenses of earning same, other than those shown in this account ...		14,680
,, Interest on Debentures		600	,, Interest on Tax Reserve Certificates		30
,, Audit Fee		100	,, Dividend from Subsidiary Company		3,800
,, Directors' Emoluments—			,, Income on Trade Investments ...		100
Fees	£60		,, Income on Quoted Investments		300
Managerial	3,000				
	3,060	3,060			
Paid by Subsidiary Company	1,500				
	£4,560				
United Kingdom taxation on profits for year—					
Profits Tax	£1,650				
Income Tax	6,510				
		8,160			
Balance, being Income for year, after Taxation		4,370			
		£18,910			£18,910
Dividends (*less* tax):					
Paid - 8% Preference, half-year to 31st Dec. 1957 ...	£230		By Income for year, after Taxation ..		4,370
Proposed - 8% Preference, half year to 30th June 1958	230		,, Balance brought forward from last year	£3,090	
Ordinary, 12½%, year to 30th June 1958	2,875		,, *Add* Over-provision for Income Tax	140	
		3,335			3,230
Balance carried forward		4,265			
		£7,600			£7,600

BALANCE SHEET AS AT 30TH JUNE, 1958.

SHARE CAPITAL AND RESERVES:	Authorised £	Issued and Fully Paid £
SHARE CAPITAL—		
8% Cumulative Preference Shares of £1 each	10,000	10,000
Ordinary Stock	50,000	40,000
	£60,000	50,000
CAPITAL RESERVE—		
Share Premium Account		3,640
REVENUE RESERVES		14,265
		67,905
AMOUNT SET ASIDE FOR FUTURE INCOME TAX		4,980
DEBENTURES—		
4% Debenture Stock (Secured)		15,000
CURRENT LIABILITIES—		
Trade Creditors	7,790	
Subsidiary Company ...	7,680	
Expenses	672	
Current Taxation	7,045	
Proposed Dividends (Net):		
Preference Shares ...	230	
Ordinary Stock	2,875	
		26,292
		£114,177

	Cost £	Depreciation £	£
FIXED ASSETS—			
Goodwill ...	10,000		10,000
Freehold Land and Buildings	22,420		22,420
Plant, Machinery and Tools	24,000	14,400	9,600
Office Furniture and Fittings	3,000	1,020	1,980
	£59,420	15,420	44,000
SHARES IN SUBSIDIARY COMPANY, at Cost ...			18,750
TRADE INVESTMENTS, at cost			3,200
CURRENT ASSETS—			
Stocks and Work in Progress		12,930	
Debtors and Prepayments ...		10,680	
Quoted Investments (Market Value £8,680)		8,020	
Tax Reserve Certificates		8,000	
Cash at Bank and in Hand		8,597	
			48,227
			£114,177

NOTE:
(1) No provision has been made for depreciation on land and buildings.
(2) Contracts for capital expenditure at 30th June, 1958, not provided for, amount to £8,000.

Directors

Notes: (1) The charge for Income Tax is found as follows:

	£
Schedule D liability ...	4,980
Tax deducted from Income on Investments, £4,200 at 8/6	1,785
	6,765
Less Recouped on Debenture Interest, £600 at 8/6 ...	255
	£6,510

(2) The overprovision for Income Tax in the previous year is £5,535—£5,395 £140.

(3) Liability for expenses comprises:

Accrued Charges ...	£500
Half-year Debentures interest, *less* tax ...	172
	£672

(4) Current taxation includes:

Schedule D, 1958-59 ...	£5,395
Profits Tax ...	1,650
	£7,045

In recent years many companies have adopted the practice of presenting their accounts in the form of financial statements, which it is considered are more easily understandable by persons having little or no knowledge of accountancy. If this procedure were followed by Veneering Manufacturers Ltd., the Profit and Loss Account and Balance Sheet shown above might appear as under.

VENEERING MANUFACTURERS, LTD.

Profit and Loss Account for the Year ended 30th June, 1958.

				£
Trading Profit for Year				8,300
after charging all expenses of earning same including:				
Provision for Depreciation		2,620		
Interest on Debentures		600		
Audit Fee		100		
Directors' Emoluments				
Fees	£60			
Managerial	4,500			
	4,560			
Less Paid by Subsidiary Company	1,500			
		3,060		
Income from Investments:				
Subsidiary Company			3,800	
Trade Investments			100	
Quoted Investments			300	
Tax Reserve Certificates			30	
				4,230
Net Income for Year before Taxation				12,530
Less United Kingdom Taxation based on profits for the year				
Profits Tax			1,650	
Income Tax			6,510	
				8,160
Net Income for Year after Taxation				4,370
Add Balance brought forward from last year			3,090	
Overprovision for Income Tax written back			140	
				3,230
				7,600
Less Appropriations:				
Dividends (*less* tax):				
Paid - 8% Preference Shares, half-year to 31st December, 1957			230	
Proposed - 8% Preference Shares, half year to 30th June, 1958.			230	
Ordinary Stock - 12½%, year to 30th June, 1958			2,875	
				3,335
				£4,265

Balance Sheet as at 30th June, 1958

	Author-ised £	Issued and Fully paid £
Share Capital and Reserves:		
Capital:		
Ordinary Stock	50,000	40,000
8% Cumulative Preference Shares of £1 each	10,000	10,000
	£60,000	50,000
Capital Reserves:		
Share Premium Account		3,640
Revenue Reserves		14,265
		67,905
Amount Set Aside for Future Income Tax		4,980
Debentures:		
4% Debenture Stock (Secured)		15,000
		£87,885

Represented by:

		Cost	Depreciation	
		£	£	£
FIXED ASSETS:				
Goodwill		10,000	—	10,000
Freehold Land and Buildings		22,420		22,420
Plant, Machinery and Tools		24,000	14,400	9,600
Office Furniture and Fittings		3,000	1,020	1,980
		£59,420	£15,420	44,000
SHARES IN SUBSIDIARY COMPANY, at cost				18,750
TRADE INVESTMENTS, at cost				3,200
CURRENT ASSETS:				
Stock and Work in Progress			12,930	
Debtors and Prepayments			10,680	
Quoted Investments (Market Value £8,680)			8,020	
Tax Reserve Certificates			8,000	
Cash at Bank and in Hand			8,597	
			48,227	
Less CURRENT LIABILITIES				
Trade Creditors		£7,790		
Subsidiary Company		7,680		
Expenses		672		
Current Taxation		7,045		
Proposed Dividends (*less* tax):				
Preference Shares	£230			
Ordinary Stock	2,875			
		3,105		
			26,292	
				21,935
				£87,885

NOTES.

(1) No provision has been made for depreciation on land and buildings.

(2) Contracts for capital expenditure at 30th June, 1958, not provided for amount to £8,000.

.... } *Directors.*
.... }

Specimens of the published accounts of a number of well-known public companies are given in Appendix B.

(k) Contingent Liabilities

This expression implies that there are certain transactions the result of which is not yet known, which may or may not involve the payment of money at some subsequent date, or that the amount of a liability is dependent upon some factor not yet decided. The Companies Act, 1948, requires a note to be made on the Balance Sheet of the general nature of contingent liabilities not provided for in the accounts and, where practicable, of the aggregate amount or estimated amount of these liabilities, if it is material.

The most familiar example of a contingent liability is that in respect of bills receivable which have been discounted but have not yet matured at the date of the Balance Sheet. If any such bills are dishonoured by the acceptors the holders will have a right of recourse against the drawers or prior indorsers. Since it is not known at the date of the Balance Sheet whether or not outstanding bills will be met in due course, a note should be inserted stating that: 'There is a contingent liability in respect of bills under discount, amounting to £ .' When, however, there is a definite expectation that certain of the bills will not be met, provision should be made

for the anticipated loss. To the extent that provision is made in the accounts, it will be unnecessary to refer to the contingent liability by way of note on the Balance Sheet.

Other instances of contingent liabilities are the uncalled liability on partly paid shares held in other companies, liabilities under guarantees, or in respect of pending actions at law, etc. Contingent liabilities may also exist in respect of contracts for work only partly performed, trade contracts, etc., but it is usual only to note on the face of the Balance Sheet the existence of those contingent liabilities which, should they accrue, might involve actual loss to the business. Other contingent liabilities, which, when they accrue, will result in the acquisition of an asset of corresponding value, are sometimes omitted; though a note should be made where the amount involved is of any consequence.

Where dividends remain unpaid on cumulative preference shares, a note of the amount thereof must be made on the Balance Sheet. These (so called) 'arrears' are not actual liabilities, but the fact of their existence is important to the members in ascertaining their respective interests in the company. The amount must be stated before deduction of income tax, unless the dividend is payable 'free of tax.'

(l) Dividends

The profits of a limited company may be distributed among the members in the form of dividends at the discretion of the directors and in accordance with the articles of the company.

In a few cases the dividend is computed on the nominal value of the shares, but usually the articles provide that the dividend shall be calculated on the amount for the time being paid up on the shares, so that no dividend would be payable on any calls in arrear. Quite commonly, however, interest is chargeable on calls in arrear, and the dividend may then be made payable on the amount called up, if permitted by the articles. If Table A applies, dividends can only be paid on the amounts paid up in all cases. Where moneys have been paid in advance of calls, Table A (1948) provides that such payments shall *not* be treated as paid up thereon. No dividend can therefore be paid on calls paid in advance, unless Table 'A' is excluded and the company's special articles permit such a payment.

A dividend is not due to members until declared by the company in general meeting, so that even preference dividends, though usually payable at fixed dates, are not recoverable against the company before declaration. The directors are usually empowered by the articles to pay interim dividends, but although directors may *pay* such dividends, they do not become debts enforceable against the company until they have been *declared* by the company in general meeting.

It is usual for companies to include in their accounts the proposed dividends and other appropriations which will be recommended by the directors for declaration at the general meeting. Such appropriations are debited to Appropriation Account and credited to Dividend Account(s), the latter being included as a liability on the Balance Sheet. Although this practice may be theoretically inaccurate (a liability being shown which may not become a debt, since the meeting might refuse to declare

the dividend or might reduce it), it is, however, so common that it must be accepted as conventional, and it has now received statutory authority in the Companies Act, 1948, which requires the amount of proposed dividends to be shown in the Profit and Loss Account and Balance Sheet.

The usual procedure in important businesses is to transfer the amount of cash payable in respect of any dividend declared to a special Dividend Bank Account, against which the dividend warrants are drawn.

In the financial books, an account is raised in respect of each dividend declared, details of the amounts due to individual shareholders being recorded in a dividends book or on dividend sheets. Dividends unclaimed are revealed by the balances appearing from time to time on the Dividend Accounts, and these are periodically transferred to an Unclaimed Dividends Account, which will appear as a liability in the Balance Sheet.

Where a company has issued share warrants to bearer, dividend coupons are usually attached thereto, and upon the notification by advertisement of the declaration of a dividend, the appropriate coupon should be detached by the holder of a warrant and paid into his bank for collection in the same manner as a cheque. If no coupons are attached to the warrants, the latter must be deposited with the secretary of the company who, after verification, will return the share warrant together with a cheque for the amount of the dividend.

Unless dividends are declared 'free of tax', income tax at the standard rate must be deducted and only the net amount of the dividend paid. The dividend warrant must state the gross amount or its equivalent, the rate and amount of tax deducted, and the net amount payable, even where the payment is 'free of tax' (Section 199, Income Tax Act, 1952).

Periodically, the total amount of the dividend warrants which have been presented for payment will be ascertained from the dividend pass book, credited to the dividend cash book, and debited to the appropriate Dividend Account, the balance of which at any time will represent the amount of dividends unclaimed. These should be treated as a liability in the Balance Sheet, the balance of cash as per the dividend pass book appearing as an asset of an equal amount.

The dividends payable are listed on dividend sheets, of which a specimen appears in the illustration given below. These sheets, which provide the data from which the dividend warrants are prepared, are written up from the share register, after all transfers have been recorded therein. The total of the *Net Dividend* column is the amount to be transferred from the general bank account to the dividend bank account. The warrants presented and paid through this account are ticked up on the dividend sheets, and any unticked items at any time represent dividends unclaimed, the total of which should agree with the balance on the Dividend Account.

Illustration

W. Ltd. has an issued capital of £100,000, all in ordinary shares of £1 each, and prepares accounts annually to 31st March.

In December, 1958, the company declared a dividend of 10 per cent., less tax, payable on 20th December, and instructed the company's bankers on the same day to transfer the sum required to pay the dividend to a special Dividend Account.

On 31st March, 1959, the dividend warrants had all been presented for payment, with the exception of two, for £5 15s. 0d. and £23 0s. 0d. respectively.

You are required:

(*a*) To give a ruling, with two specimen entries, of a dividend sheet suitable for use in recording the dividend; and

(*b*) To set out the ledger entries involved, including the Dividend Bank Account, bringing down the balances as on 31st March, 1959. Income Tax is to be taken into account at 8s. 6d. in the £.

DIVIDEND SHEET

DIVIDEND FOR YEAR ENDING 31ST MARCH, 1959

No. of Dividend....40.... Rate: 10 per cent. Payable 20th December, 1958

Members' Names and Addresses	Share Register Folio	Number of Shares	Dividend Gross £ s. d.	Tax at 8/6 £ s. d.	Net £ s. d.	Warrant No.	Special Instructions and Remarks
A. Jones, 14 High Street, Manxton	1	1,000	100 0 0	42 10 0	57 10 0	681	
B Robinson, The Hollies, Wroxton.	2	660	66 0 0	28 1 0	37 19 0	482	Payable to Barclays Bank Ltd. Head Office.

DIVIDEND No. 40 ACCOUNT

			£ s. d.			£ s. d.
1959 Mar 31	To Dividend No. 40 Bank Account		5,721 5 0	1959 Mar. 31	By Profit and Loss Appropriation Account – Dividend of 10 per cent. on £100,000, less tax at 8/6 in £ declared 20th Dec., 1958	5,750 0 0
	„ Unclaimed Dividends Account		28 15 0			
			£5,750 0 0			£5,750 0 0

DIVIDEND No. 40 BANK ACCOUNT

		£ s. d.			£ s. d.
1958 Dec. 20	To General Bank Account	5,750 0 0	1959 Mar. 31	By Dividend No. 40 Account—Dividends Paid . . .	5,721 5 0
				„ Balance c/d .	28 15 0
		£5,750 0 0			£5,750 0 0
1959 April 1	To Balance b/d.	28 15 0			

UNCLAIMED DIVIDENDS ACCOUNT

		£ s. d.			£ s. d.
1959 Mar. 31	To Balance c/d. ..	28 15 0	1959 Mar. 31	By Dividend No. 40—Warrants not presented—	
				A	5 15 0
				B	23 0 0
		£28 15 0			£28 15 0
			1959 Apr. 1	By Balance b/d.	28 15 0

PROFIT AND LOSS APPROPRIATION ACCOUNT

1959		£ s. d.
Mar. 31	To Dividend of 10 per cent. *less* tax, on 100,000 Ordinary Shares of £1 each	5,750 0 0

(m) The treatment of Taxation in the Accounts of Companies

The following is a summary of the recommendations on this important subject made by the Council of the Institute of Chartered Accountants in England and Wales in October 1958.

Basis of the charge and of amounts provided and set aside for income tax

(*a*) The charge for income tax should preferably be based on the profit for the year and should be so described.

(*b*) Any material adjustment in respect of amounts charged in previous years should be shown separately.

(*c*) New companies should preferably set aside from profits an additional amount, to be shown separately, for or towards the balance of the tax payable for the current and following income tax years until all income tax based on profits to date has been set aside.

(*d*) Companies whose practice has been to charge only the accrued proportion of the current year's assessment should preferably set aside from current or accumulated profits an additional amount, which should be shown as a separate item, for or towards the balance of the tax payable for the current and following income tax years until the full amount to cover all income tax based on profits to date has been set aside.

The balance sheet should show by note or otherwise the basis on which the amounts included for income tax have been computed; if the full amount of tax on all profits to date is not set aside, this should be made clear.

Amounts set aside for future income tax (apart from amounts set aside because depreciation and capital allowances differ) should consist only of:

(*a*) any amount set aside in respect of estimated tax for the income tax year commencing after the balance sheet date; and

(*b*) the proportion of the current year's income tax for the period from the balance sheet date to the following April 5th, if the amount included under current liabilities is calculated on the basis of a day-to-day accrual of the income tax assessed for the income tax year in which the accounting year ends.

Amounts set aside for future income tax whether described as reserves or not, *should be shown separately* and should preferably *not* be aggregated with reserves. Income tax assessable for any income tax year commencing after the balance sheet date should not be grouped with liabilities.

Income taxed at source and under Schedule A

Dividends, interest and other income should be brought to credit gross and should therefore include income tax suffered by deduction, or deemed for income tax purposes to have been suffered by deduction on such income. The relative amount of income tax should be included as part of the charge for income tax for the year.

Income tax assessed under Schedule A and not recovered by deduction from rent paid forms part of the income tax charge of the paying company and should be included in the charge for income tax.

Annual charges

Debenture, loan and note interest, royalties and other annual charges payable under deduction of income tax should be charged *gross* in the profit and loss account.

Dividends payable

The amounts shown in the accounts in respect of dividends paid or payable should be the *net* amounts, whether they are declared as 'subject to income tax', 'less income tax' or 'free of income tax'.

Claims for relief under Section 341, Income Tax Act 1952, in respect of trading losses

A company which bases its charge for income tax on the profit of the year should adopt the following procedure when it incurs a trading loss entitling the company to relief under Section 341:

(*a*) If the income tax relief under Section 341 is dealt with in the accounts for the year in which the trading loss is incurred:

(i) where the relief obtainable under Section 341 is less than the tax on income from other sources, the charge for income tax should be shown after taking relief into account, and should be described as income tax based on the profit for the year;

(ii) where the relief obtainable under Section 341 exceeds the tax on income from other sources the excess should be shown as income tax recoverable;

(iii) the amount of income tax recoverable should be set off in the balance sheet either as a deduction from current liabilities for tax or from amounts set aside for future tax, as may be appropriate; or as an asset reduced by current liabilities for tax or by amounts set aside for future tax.

(*b*) If the income tax relief under Section 341 is not dealt with in the accounts in which the trading loss is incurred:

(i) in the accounts for the year in which the trading loss is incurred an indication should be given, if the amount is material, that no credit has been taken for the potential income tax recovery under Section 341;

(ii) when the relief is brought into the profit and loss account in a subsequent year it should be disclosed separately as an adjustment relating to a previous year.

Relationship of charges for income tax and profits tax to profits

The treatment of income tax in the manner recommended above will not necessarily ensure that an adequate amount is set aside for tax payable in the future on profits to date, or that the profit and loss account shows a tax charge which is appropriate in relation to the profit for the year. The reason for this is that there may be material differences between the treatment of items for accounting purposes and their treatment for tax purposes, in particular, the amounts charged for depreciation may differ from the capital allowances for tax purposes and this difference may involve substantial deferment of tax liability.

There are various reasons why capital allowances differ from depreciation charges and therefore affect the relation of the tax charge to the profit of the year. These reasons include the claiming of initial allowances, which have the effect of reducing future annual allowances; the incidence of balancing charges and balancing allowances; the fact that there are usually differences between the rates of and methods of calculating annual allowances as compared with those used for calculating depreciation; the granting of investment allowances, which give relief in addition to normal capital allowances; and the fact that there are some assets for which depreciation or amortisation is provided but which do not attract capital allowances (for example, commercial buildings and leases), and some for which the capital allowances are based on a smaller amount than the depreciation provisions (for example, industrial buildings and assets which have been written up on a revaluation).

The foregoing and other matters are considered in the following paragraphs.

Tax deferred by Capital Allowances

The result of obtaining initial allowances is to defer to subsequent years a part of the tax which should otherwise be payable on the profit of the year. Accordingly a practice has developed of setting aside and spreading over a period of years the temporary tax benefit

resulting from initial allowances. Under this practice capital allowances including initial allowances are compared with the capital allowances which could have been granted if no initial allowances had been granted either for the year under review or for preceding years. This comparison discloses the amount on which tax has been deferred by initial allowances, and tax on this amount is set aside to meet, when payable, the tax so deferred.

Some companies have extended the above principle in order to take into account the fact that temporary tax benefits (and therefore deferment of tax liability) may result from capital allowances (other than investment allowances) taken as a whole and not merely when initial allowances are obtained. This extension is achieved by maintaining the total set aside for tax deferred by capital allowances at an amount equal to income tax and profits tax on the excess of:

(*a*) the net amount at which the relevant fixed assets are stated in the balance sheet (excluding any part which does not attract capital allowances) over;

(*b*) the amount to which they have been written down for capital allowances purposes by allowances which have been effectively used in computing amounts charged or set aside for income tax.

If material, the amount of tax deferred by capital allowances should preferably be set aside and shown in the balance sheet, with appropriate description, as a separate item which may be grouped with 'future tax'. An amount so set aside should represent tax at current rates on the excess of:

(*a*) the net amount at which the relevant fixed assets are stated in the balance sheet, over

(*b*) the written-down value of those assets for capital allowance purposes,

after making such adjustments as may be necessary for any part of the amount of (*a*) which does not attract capital allowances (*e.g.*, because of a revaluation); and increasing (*b*) by an amount equal to any capital allowances which have not been effectively used in computing amounts charged or set aside for income tax.

Where the above practice is adopted the amount to be dealt with in the profit and loss account each year (to increase or reduce the amount set aside) will be the difference between the amount of tax deferred by capital allowances at the end of the accounting period and the amount at the beginning of the period. This increase or decrease may be taken into account in arriving at the tax charge for the year, and if the effect is material, the description of the basis of the charge for tax should indicate the course followed and the amount involved.

If a change in rates of tax materially affects an amount already set aside for tax deferred by capital allowances, the fact should be disclosed.

Where the practice of setting amounts aside for tax deferred by capital allowances is not adopted, there should be indicated the extent, if material, to which depreciation will require to be provided, in future, without relief from tax, and the effect of capital allowances which have materially distorted or even extinguished the tax charge should be indicated.

Investment allowances

Tax relief on investment allowances should not be deducted from the cost of the assets; it should be treated as a reduction of the tax charge in the profit and loss account. The extent to which the charges for tax are affected should be stated, if the tax relief is material.

Depreciation to be provided out of taxed profits

Where depreciation is provided on assets which do not attract capital allowances, or which attract capital allowances based on a smaller amount than that used for calculating the provisions, the position should be disclosed clearly in the accounts, and the amount, if material, to which depreciation will have to be provided in the future without tax relief should be indicated.

Other special factors and items of exceptional or non-recurrent matters

The tax charge may be distorted in relation to profits by factors such as relief for past losses.

the carrying forward of losses in preference to claiming relief under Section 341, the allowance for tax purposes in one year of expenditure charged against provisions made in previous years, and the treatment for tax purposes on a 'renewals' basis of assets on which depreciation is provided in the accounts, etc.

The net effect of special factors which have materially distorted, whether upwards or downwards, or even extinguished the tax should be indicated.

If any reference is made in accounts to the potential tax saving expected from items which may reduce substantially or even eliminate tax chargeable on future profits it should be made clear that the potential tax saving is dependent upon future profits against which such items can be utilized.

Where exceptional items are not taken into account before arriving at 'profit before taxation' the effect of these items on the amount shown in respect of tax should be considered; where appropriate the relative tax charges or reliefs should be shown as separate adjustments to the respective items.

If a provision for expenditure to be met in the future is computed after taking into account potential tax saving the fact that it is so computed should be made clear.

Subsidiaries controlled and trading overseas

When consolidated accounts include profits and reserves of subsidiaries controlled and trading overseas which on distribution as dividends to the holding company would be subject to:

(*a*) overseas distribution taxes (if any); and

(*b*) United Kingdom income tax and profits tax (after appropriate double tax relief)

then such observations as may be appropriate should be given by way of note or otherwise in regard to the tax position if the tax resulting from distribution would be material.

Similarly information should be given regarding the charge for tax on the profit of the year where a material amount of profit has not been subjected to United Kingdom tax. The tax charge for the year should be suitably described.

Surtax

Where a trading company to which Section 245 of the Income Tax Act, 1952, applies has not distributed a reasonable part of its income for the year the Special Commissioners may direct that the income shall be apportioned among the members and charged to surtax at the rates appropriate to those members. Unless the individual members themselves elect to meet the liability it must be borne by the company. In the case of an investment company falling within the section the making of a direction in respect of the whole of the investment income is automatic, and is not dependent upon the non-distribution of a reasonable part of the income. If a clearance has not been obtained in respect of past years, there is a possibility that the Inland Revenue may make a direction for any or all of the previous six years.

It is not normally necessary for the accounts of a trading company to which the section applies to refer to the contingent liability for surtax, unless it appears probable that the Inland Revenue intend to make a direction. Where the company is an investment company to which the section applies, a note referring to the existence of the contingent liability for surtax is normally necessary.

Tax Reserve Certificates

Tax Reserve Certificates held should be shown as a separate item in the balance sheet and grouped with current assets.

Interest allowed on Tax Reserve Certificates when used to pay taxes should be treated as interest and not as a reduction of the tax charge.

If credit is taken for interest accrued to the date of the balance sheet it should be confined to interest on certificates which have since been applied in payment of taxes.

Illustration

At 1st January, 1958, B Ltd. had a credit balance brought forward on Income Tax Account of £32,000, which was made up of amounts set aside for:

Income Tax, Schedule D 1957/58	£16,250
,, ,, ,, 1958/59	15,300
,, ,, Schedule A 6th April to 31st Dec., 1957—$\frac{3}{4} \times$ £600... ...	450
	£32,000

The company held the following Tax Reserve Certificates:

£20,000 purchased 31st August, 1956

£10,000 purchased 30th June, 1957.

During the year 1958 the following transactions took place:

1st January	Paid $\frac{1}{2}$ year's dividend due 31st December, 1957, on 50,000 6% Preference Shares of £1 each.
6th ,,	Received Quarter's Interest on £10,000 $2\frac{1}{2}\%$ Consols.
28th ,,	Paid Schedule A Tax, £600 and Schedule D Tax £16,250 for 1957/58, by surrendering £16,675 Tax Reserve Certificates on which the interest allowable is £166 15s. 0d., and the balance in cash.
31st March	Paid $\frac{1}{2}$ year's Interest, on £30,000 4% Debentures.
6th April	Received Quarter's Interest on £10,000 $2\frac{1}{2}\%$ Consols.
15th May	Paid dividend for 1957 of 10% less tax on 100,000 ordinary shares of £1 each, fully paid.
1st July	Paid $\frac{1}{2}$ year's dividend due 30th June, 1958 on 50,000 6% Preference Shares.
6th July	Received quarter's interest on £10,000 $2\frac{1}{2}\%$ Consols.
30th Sept.	Paid $\frac{1}{2}$ year's Interest on £30,000 4% Debentures.
6th October	Received quarter's interest on £10,000 $2\frac{1}{2}\%$ Consols.
31st October	Purchased £20,000 Tax Reserve Certificates.
31st Dec.	Schedule D liability for 1958/59 has been agreed at £15,000. The liability for 1959/60, based upon the profits for 1958 is estimated at £17,500.

Write up the accounts relating to Income Tax and Tax Reserve Certificates for the year ended 31st December, 1958.

INCOME TAX ACCOUNT

Date			£ s. d.	Date			£ s. d.
1958				1958			
Jan 6	To Consols Interest Account £62 10 0 at 8/6 in £		26 11 3	Jan. 1	By Balance b/f		32,000 0 0
Jan. 28	,, Tax Reserve Certificates Account	£16,675 0 0		Mar. 31	,, Debenture Interest Account— £600 at 8/6 in £ . ..		255 0 0
	,, Interest on Tax Reserve Certificates Account	166 15 0		Sep. 30	,, ,, ,, ...		255 0 0
	,, Cash .	8 5 0	16,850 0 0	Dec. 31	,, Profit and Loss Account: ,, Charge for year	£17,696 5 0	
	Discharging— Sch. A Tax 1957/58	£600			*Less* Overprovision for Schedule D tax for 1958-59	300 0 0	17,396 5 0
	,, D ,, ,,	16,250					
		£16,850					
Apr. 6	,, Consols Interest Account— £62 10 0 at 8/6 in £		26 11 3				
July 6	,, ,, ,, . .		26 11 3				
Oct. 6	,, ,, ,, ...		26 11 3				
Dec. 31	,, Balance c/d. Sch. A 1958/59 $\frac{3}{4} \times$ £600	£450					
	Sch. D 1958/59	15,000					
	Sch. D 1959/60	17,500	32,950 0 0				
			£49,906 5 0				£49,906 5 0
				1959 Jan. 1	By Balance b/f.		32,950 0 0

TAX RESERVE CERTIFICATES ACCOUNT

			£					£
[illegible]				1958				
Jan.	1	To Balance b/f.	30,000	Jan.	28	By Income Tax Account—Certificates surrendered		16,675
Oct.	31	„ Cash—Purchase of £20,000 Certificates	20,000	Dec.	31	„ Balance c/d. . ..		33,325
			£50,000					£50,000
1959								
Jan.	1	To Balance b/d.	33,325					

INTEREST ON TAX RESERVE CERTIFICATES ACCOUNT

			£ s. d.				£ s. d.
1958				1958			
Dec.	31	To Profit and Loss Account ..	166 15 0	Jan.	28	By Income Tax Account—Interest on Certificates surrendered ...	166 15 0

Note

The transfer to Profit and Loss Appropriation Account at 31st December, 1958, is made up as follows:

	£	s.	d.
Schedule A Tax, 1958	600	0	0
Amount set aside for Schedule D Tax, 1959/60	17,500	0	0
Tax on Consols Interest	106	5	0
	18,206	5	0
Less Tax recouped on Debenture Interest	510	0	0
Charge for year	17,696	5	0
Less Overprovision for Schedule D Tax for 1958/59	300	0	0
	£17,396	5	0

The over-provision for 1958-59 should be added to the balance of Profit and Loss Account brought forward from the previous year as in the illustration on p. 298.

(n) Profit and Loss and Appropriation Account

Whereas the capital of a sole trader or partnership can be varied at will or by agreement, that of a limited company is only alterable in accordance with the provisions of the Companies Act. Profits must not, therefore, be carried to the Capital Account of a company, but must be kept separate. In order to distinguish the actual profits earned from the profits available for dividend, the former are ascertained by means of a separate Profit and Loss Account for each period, while the latter are shown by a Profit and Loss Appropriation Account, to which all profits or losses shown by the periodical Profit and Loss Accounts are transferred, and to which are debited all appropriations of profit such as transfers to reserves, dividends, etc.

Any balance not specifically appropriated will remain to the credit of the Appropriation Account, and is technically known as the 'carry forward.'

In some instances, in exceptionally good years, an appropriation is made to a reserve known as the Dividends Equalisation Account, which can be drawn upon in

future years as and when necessity demands. This course tends to maintain dividends at an even rate and is consequently reflected in the value of the shares on the market.

From a strictly legal viewpoint, income tax should be regarded as an appropriation of, and not a charge against profit (*Johnstone* v. *Chestergate Hat Manufacturing Co. Ltd.* (1915), 2 Ch. 338), and should be debited to the Appropriation Account. In practice, however, most companies debit the amount set aside for income tax on profits to the Profit and Loss Account itself, before arriving at the balance of profit which is carried down to the Appropriation Account. This is done because income tax is charged on the full amount of the profits, before paying any dividends thereout, and the amount of profit available for the payment of dividends and other appropriations cannot be revealed until full provision for income tax on the profits has been made. Taxation is accordingly debited to Profit and Loss Account in order to make it clear to the members that the balance carried to the Appropriation Account is the amount of profit actually available for distribution as *net* dividends, *i.e.*, after deduction of income tax.

(o) Calculation of Remuneration based on a Percentage of Profits

Frequently, the managing director or other servant or officer of a company is entitled under his service agreement to remuneration calculated at a percentage of the profits of the company. In such a case it is essential, if controversy and possible litigation are to be avoided, that the agreement should contain precise directions as to the manner in which the profits shall be ascertained for this purpose. In particular, the following matters should be dealt with:

1. Whether the remuneration is to be calculated only on trading profits or on the profits and income from all sources. In the absence of express provisions, it would appear from the decision in *Re Spanish Prospecting Co. Ltd.* (1911), L. J. Ch. 210, that the term 'profits', for this purpose, must be deemed to mean the amount by which the total assets, less liabilities, have increased during the period in question, after making allowance for any capital introduced or withdrawn during the same period.

2. Whether depreciation of fixed or wasting assets is to be charged before arriving at the profits. In *Edwards* v. *Saunton Hotel Ltd.* (1942) T.R. 359, it was held that adequate provision for depreciation should be made, but that in the absence of agreement on the point it should be calculated on the *straight line method*, and not by the reducing instalment system, as the latter would impose a disproportionate charge on the profits in the early years of the life of the assets.

3. To what extent, if at all, are the directors to be entitled to make provision out of profits for contingencies, or to write off intangible assets or transfer profits to reserve. In *Fisher* v. *Black and White Publishing Company Ltd.* (1901), 1 Ch. 174, it was held that directors may transfer so much of the profits as they consider necessary to reserve before arriving at the fund which shall be available for the payment of dividends.

4. It was decided in *Johnstone* v. *Chestergate Hat Manufacturing Co.* [1915] L.J. 84, Ch. 914, that where a manager of a company is entitled to a percentage of net profits, income tax must not be deducted before arriving at the sum on which the remuneration is to be calculated, and this ruling was followed in *Attorney-General* v. *Ashton Gas Company* [1906] A.C. 10, where it was held that income tax is part of the profits, *viz.*, the part which the Revenue is entitled to take. On the other hand, in *Re Agreement of G. B. Ollivant, Ltd.* [1942] T.R. 295, in which the question at issue was the ascertainment of the amount of the net profits of a business which had been sold, for the purpose of arriving at the sum on which the price to be paid as consideration for the goodwill of the business was to be based, it was held that in drawing up the Profit and Loss Account of a trading company, the excess profits tax must be deducted if ordinary commercial practice is to be followed.

No judicial opinion has yet been expressed on the question whether profits tax should, in the absence of agreement on the point, be deducted in arriving at the net profits, but since, like income tax itself, this tax is not now deductible in calculating profits for income tax purposes, it is reasonable to assume that it should be treated in a similar manner to income tax in arriving at the net profits for other purposes, in which case it would not be deductible. It must be remembered that the excess profits tax *was* an allowable deduction from profit for the purposes of income tax, and it may have been this fact which influenced the Court in deciding, in the *Ollivant* case, that it ought to be deducted in arriving at the net profit of the business on the basis of which the consideration to be paid for goodwill should be calculated.

5. The agreement should state whether the remuneration is to be calculated on the profits before or after charging such remuneration. In *Edwards* v. *Saunton Hotel Ltd.* (*see ante*) where the commission was to be calculated on the profit 'available for distribution each year', it was decided that the remuneration itself should *not* be deducted from the profits before ascertaining the amount on which the remuneration is to be calculated; the agreement may, of course, vary this.

Illustration

The managing director of a company is employed under a service agreement which states, *inter alia*, that he is to be remunerated by way of a commission, calculated at the rate of 5 per cent. per annum on the net trading profits of the company. The following Profit and Loss Account has been prepared before calculating the commission:

	£		£
To Office and Administrative Expenses	27,420	By Balance from Trading Account ...	95,160
" Selling Expenses	14,450	" Income from Investments (gross)	1,600
" Depreciation	3,600	" Discounts	550
" Interest on Debentures (gross)	2,000	" Profit on sale of Investments	240
" Directors' Fees ...	1,000		
" Preliminary Expenses, written off	500		
" Income Tax	13,320		
" Profits Tax ...	8,200		
" Transfer to General Reserve	5,000		
" Transfer to Sinking Fund for Redemption of Debentures	3,000		
" Transfer to Superannuation Fund	3,200		
" Balance carried down	15,860		
	£97,550		£97,550

The superannuation fund is a contributory one and is created under an irrevocable trust.

CALCULATION OF COMMISSION

		£	£
Balance of Profit and Loss Account			15,860
Add:	Preliminary Expenses written off	500	
	Income Tax	13,320	
	Profits Tax	8,200	
	Transfer to General Reserve	5,000	
	Transfer to Sinking Fund for redemption of Debentures	3,000	
			30,020
			45,880
Deduct:	Income from Investments	1,600	
	Profit on sale of Investments	240	

Commission—5% on £44,040 = £2,202

Notes

1. The amounts written off Preliminary Expenses and transferred to General Reserve and Sinking Fund are appropriations of profit and should not be deducted in arriving at the 'net trading profit'.
2. Income from investments and profit on sale of investments are not part of the trading profit and are excluded. If, however, the agreement had provided for the commission to be based on 'net profit', they would have been left in.
3. If depreciation has not been calculated on the fixed instalment system it should be recomputed, in the absence of specific agreement to calculate it by some other method.
4. Profits tax has not been deducted, since it is not now allowable as a deduction for the purposes of income tax, but judicial confirmation of this treatment is not at present available.

§ 16 The Amalgamation of Companies

Amalgamations take many forms, from the pooling of profits, etc., to complete mergers. This section is devoted to complete amalgamations, where either an existing company absorbs other businesses, or a new company is formed to acquire existing businesses. The matters to be considered in the preliminary stages, the valuation of assets, and the legal formalities to be complied with, are outside the scope of a work on accountancy, and we are here only concerned with the accounting entries involved on an amalgamation.

Where a new company is formed to take over the businesses of two or more existing companies, it becomes necessary to revalue the assets (including goodwill) of each of those companies in order to ascertain the total value of its issued share capital and to determine the amount of the consideration which the transferee company should pay for each of the businesses acquired. It is usual for the consideration to be satisfied by the issue of fully paid shares in the new company to be allotted to the shareholders of the old companies in proportion to their respective holdings and having regard to the relative values of their shares.

For the purposes of the amalgamation the amount of the consideration for the acquisition of a business may be arrived at either by valuing its individual assets and goodwill or by valuing the business as a whole by reference to its earning capacity.

If the first method is employed the fixed assets of all the amalgamating companies should preferably be valued by the same professional valuer on a going concern basis.

The term 'going concern' means that a business is being operated at not less than a normal or a reasonable profit and the valuer will assume that the business is earning reasonable profits when appraising the assets. If it is found, when all the assets of the business, both fixed and current, have been valued, that the profits represent more than a fair commercial return upon the capital employed in the business as shown by such valuation, the capitalised value of the excess (or super profits) will be the value of the goodwill, which must be added to the values of the other assets in arriving at the consideration to be paid for the business. If, however, the profits are less than a fair commercial return upon the capital employed a deficit may be regarded as 'bad-will' and something will have to be deducted from the aggregate of the valuations of the assets to allow for this in arriving at the consideration to be paid.

If the second method is employed the value of the business is taken to be the capital sum which, on the basis of the expected percentage of yield, would provide an annual income equal to the average maintainable profits of the business. For example, if the average maintainable profits of a business amount to £10,000 and the rate of yield expected on an investment in the particular business is 10%, the value of the business is £100,000. This would represent the total value of all the assets, including the goodwill (or less the 'bad-will' as the case may be), and less the liabilities.

In either case the ultimate amount of the consideration arrived at will represent the value of the business as a whole, having regard to its capacity to earn revenue. (The various methods of computing the value of goodwill are explained and illustrated in Chapter VII, Section 5.)

Where the shares of the original companies are quoted on the Stock Exchange, such quotation would generally afford a reliable guide as to the values at which they should be acquired, unless the shares are peculiarly subject to speculative influences. If any rumour of the proposed amalgamation leaks out, the quotations may, of course, cease to be reliable, as speculative dealings are almost sure to ensue. Some little concession in value is usually made to induce members to agree to the scheme.

Illustration (1)

Two companies, whose businesses are of a similar kind, and whose assets are properly valued, agree to amalgamate, and a new company is formed with an authorised capital of £200,000 to take over their respective assets and liabilities. The following are the respective Balance Sheets:

JONES & JOHNSON, LIMITED

BALANCE SHEET AS AT 31ST DECEMBER

	£		£
Share Capital – Authorised and Issued:		Goodwill	30,000
75,000 Shares of £1 each fully paid	75,000	Freehold Premises	10,000
Reserve Account	4,200	Plant and Machinery	18,300
Profit and Loss Account	800	Stock	16,000
Liabilities	3,300	Sundry Debtors	7,500
		Cash	1,500
	£83,300		£83,300

BLACK & SONS, LIMITED
BALANCE SHEET AS AT 31ST DECEMBER

	£		£
Share Capital – Authorised £50,000		Goodwill ..	20,000
		Plant and Machinery	13,450
Issued – 45,500 Shares of £1 each fully paid	45,500	Stock ..	11,550
Profit and Loss Account	4,500	Sundry Debtors	6,000
Liabilities	2,000	Cash ..	1,000
	£52,000		£52,000

The book value of the net assets of Jones & Johnson, Limited, is arrived at as follows

	£	£
Gross Assets ..	83,300	
Less Liabilities	3,300	
		£80,000

From the shareholders' point of view, this amount is represented by:

	£
Share Capital	75,000
Reserve Account ..	4,200
Profit and Loss Account ..	800

In a similar manner the book value of the net assets of Black & Sons, Limited, is £50,000, represented as follows:

	£	£
Share Capital	45,500	
Profit and Loss Account ..	4,500	
		£50,000

Assuming the assets of each company to be taken over at their book values, the liabilities of each company to be assumed, and the consideration to be discharged by shares in the new company issued at par, shares in the new company should be allotted as follows:

To the shareholders of Jones & Johnson, Limited, 80,000 shares of £1 each fully paid, being at the rate of 16 new shares for every 15 old; and

To the shareholders of Black & Sons, Limited, 50,000 shares of £1 each fully paid, being at the rate of 100 new shares for every 91 old.

Fractions of shares will require to be dealt with. The usual method is to allot to the liquidator of the company concerned the number of shares represented by the addition of the fractions. He will realise these shares at the best price possible, and distribute the proceeds to the parties entitled thereto.

In other cases, fractional rights certificates are issued with the shares, leaving the individual members to sell their fractional rights, arrangements being made for some person or persons to hold themselves out as willing to buy the fractions. The persons acquiring them will be issued with share certificates on their producing to the company enough fractions to make a whole share or shares.

(In some instances, it is possible to avoid fractions by altering the denomination of the shares, *e.g.*, instead of allotting 6 new £1 shares for each 5 old, allotting 12 new 2s. shares for each £1 old share.)

The Balance Sheet of the new company will then be as follows:

NEW COMPANY'S BALANCE SHEET, 31st December

	£		£
Share Capital – Authorised 200,000 shares of £1 each £200,000		Goodwill	50,000
		Freehold Premises	10,000
		Plant and Machinery	31,750
Issued 130,000 Shares of £1 each fully paid	130,000	Stock	27,550
Sundry Creditors	5,300	Sundry Debtors	13,500
		Cash	2,500
	£135,300		£135,300

It will be noticed that the Reserve and Profit and Loss Account balances of the transferor companies do not appear as such in the books of the transferee company, as they are not available for revenue purposes in the hands of that company, being represented by net assets purchased and paid for out of capital.

Since the new company in the above illustration is formed for the purpose of acquiring the undertakings of other companies and the consideration for the acquisition consists as to not less than 90 per cent. thereof of shares in the new company, relief from the payment of the *ad valorem* duty can be claimed under Section 55, Finance Act, 1927 (as amended by Section 31, Finance Act, 1928, and Section 41, Finance Act, 1930).

These provisions cover the following cases:

(1) Where a new limited company is formed, or the capital of an existing limited company is increased, for the purpose of *acquiring the undertaking or part of the undertaking of another company*, and *at least 90% of the consideration for the acquisition* (other than any arrangements for taking over or paying off creditors) *consists of the allotment of shares in the transferee company* to the transferor company or to the transferor company's members.

(2) Where a new limited company is formed, or an existing limited company increases its capital, for the purpose of *acquiring at least 90% of the issued share capital of another company*. In this case, the buying company becomes a holding company, and if *at least 90% of the consideration consists of the allotment of shares in the holding company to the shareholders of the existing company* in exchange for their shareholdings, the scheme comes within the relief provisions.

In either of the above cases, for the purposes of charging capital duty on the nominal capital or increased capital, as the case may be, that capital is deemed to be reduced by an amount equal to the share capital of the vending or subsidiary company. Thus, in the above illustration, the new company would only pay stamp duty on £75,000, *i.e.*, the excess of its nominal capital over the nominal capitals of the transferor companies. If, however, only part of the undertaking of the other company is acquired, then the reduction is that proportion of the share capital of that company which the part of the undertaking acquired bears to the whole undertaking. But if the shares issued as consideration are partly paid, only the amount

Report

1. Assuming all necessary adjustments to have been made in the valuation of the assets of the respective companies as disclosed by the Balance Sheets the net capital employed in the businesses is as follows:

	A	B	C
	£	£	£
Fixed Assets	34,500	9,400	11,900
Current Assets (exclusive of Investments)	13,200	9,200	6,465
	47,700	18,600	18,365
Less Liabilities	1,500	2,200	400
Net Capital employed	£46,200	£16,400	£17,965

2. The average trading profits for the past three years are as follows:

	A	B	C
Year	£	£	£
1	6,750	3,500	4,000
2	7,425	3,750	4,400
3	8,100	4,000	3,200
	3)22,275	3)11,250	3)11,600
	7 425	3,750	3,870 (appr
Less Income from Investments (assumed yield 3½ per cent.)	175	77	—
Average trading profits	£7,250	£3,673	£3,870

3. It is assumed that under present conditions a yield of 8 per cent. ought reasonably to be provided on capital employed in businesses of the type carried on by the three companies. On this basis the annual super-profits earned by the companies are:

	A	B	C
	£	£	£
Average trading profits	7,250	3,673	3,870
Less 8 per cent. on capital (employed)	3,696	1,312	1,437
Super-Profits	£3,554	£2,361	£2,433

4. It is suggested that the goodwill be based, in the cases of A and B, on 5 years' purchase, and in the case of C (since the profits show a downward trend) on 3 years' purchase, of the super-profits.

Assuming the market value of the investments to be that disclosed by the balance sheets, the purchase consideration of the respective undertakings may be computed as follows:

	A	B	C
	£	£	£
Total Assets	52,700	20,800	18,365
Goodwill	17,770	11,805	7,299
	70,470	32,605	25,664
Less Creditors	1,500	2,200	400
	£68,970	£30,405	£25,264
Say	£69,000	£30,000	£25,000

5. If the capital of the new company is to consist of shares of £1 each issued at par, the total consideration will be discharged by the issue of 124,000 shares, to be allotted to the shareholders of the respective companies as follows:

A – 69 shares in the new company for every 27 shares in the old company (or 23 for every 9).
B – 30 shares in the new company for every 10 shares in the old company (or 3 for every 1).
C – 25 shares in the new company for every 16 shares in the old company.

Alternatively, if it is desired to avoid the liability for stamp duty which would be entailed by an increase in capital, the capital of the new company may consist of 53,000 shares of £1 each issued at a premium of £1 6s. 10d. (approx.) to be allocated as to:

$\frac{69}{124} \times 53{,}000 = 29{,}500$ (approx.) to the shareholders of A (being 59 new shares for every 54 old).

$\frac{30}{124} \times 53{,}000 = 13{,}000$ (approx.) to the shareholders of B (being 13 new shares for every 10 old).

$\frac{25}{124} \times 53{,}000 = 10{,}500$ (approx.) to the shareholders of C (being 21 new shares for every 32 old).

The book-keeping entries involved in an amalgamation are similar to those on an absorption of one company by another, and are described and illustrated in the next paragraph.

§ 17. The Absorption of one Limited Company by another

Where the constitution and position of one of the merging companies make it possible and practicable, the amalgamation may be carried out by that company absorbing the other concerns, thus avoiding the expense and trouble of forming a new company.

The companies to be absorbed will go into voluntary liquidation, and the purchasing company will usually take over the whole of the assets and ordinary trade liabilities, any debentures being either paid off in cash or exchanged for debentures in the purchasing company.

(a) Book-keeping entries for closing the Vendor Company's books

These entries in the books will be similar to those required for the purpose of closing the books of a firm on dissolution, *viz.*:

(1) Transfer to the *debit* of a Realisation Account all the balances of accounts representing assets to be taken over by the purchasing company.

(2) Transfer to the *credit* of Realisation Account any liabilities to be taken over by the purchasing company. (Alternatively, the liabilities taken over may be transferred to the credit of the Purchasing Company's Account).

(3) *Debit* the Purchasing Company's Account, and *credit* Realisation Account with the amount of the purchase consideration, *i.e.*, the agreed sale price of the assets, less the liabilities taken over. (If, however, the liabilities taken over have been transferred to the credit of the Purchasing Company's Account, the credit to Realisation Account will be the full value at which the assets are taken over without any deduction for liabilities.)

(4) *Credit* the Purchasing Company's Account, and *debit* the relevant accounts in respect of the various items forming the purchase consideration, *i.e.* Cash, Shares, in Purchasing Company, etc.

(5) *Credit* Cash and *debit* the Realisation Account with any expenses paid by the vendor company.

(6) If any assets are not taken over by the absorbing company, but are sold for cash to third parties, *debit* Cash and credit the relevant Asset Accounts with the proceeds, transferring the profit or loss on sale to the Realisation Account. Similarly, any loss or profit on paying off liabilities not taken over by the purchasing company, *e.g.*, discounts received from creditors, must be transferred to Realisation Account.

(7) The balance on the Realisation Account will represent profit or loss, which should be transferred to Sundry Members Account.

(8) Any revenue balances, such as a balance on Profit and Loss Account, Reserve Account, etc., should be transferred to the Sundry Members Account, together with the balance of the Share Capital Account. Similarly, balances representing fictitious assets, such as preliminary expenses not yet written off must be closed off by transfer to the Sundry Members Account. Where there are several classes of shareholders, it may be necessary to open a separate account for each class, or provide separate columns in the one account, in order to adjust their rights.

(9) *Debit* the Sundry Members Account and credit Cash, Shares in the Purchasing Company Account, etc., with the cash paid and shares, etc. issued to the members out of the purchase consideration when the distribution thereof takes place. This will close the books of the vendor company.

Where provision for depreciation of assets has been credited to a separate Provision for Depreciation Account, this account should be closed by transfer to the credit of Realisation Account since it represents a reduction in the book value of the assets transferred.

A provision for bad and doubtful debts must be dealt with on its merits. If the debts are taken over by the absorbing company at their book value less the provision for doubtful debts, the latter account should be transferred to the credit of Realisation Account; if, however, the debts are taken over at their full value, the provision must be transferred to the credit of Sundry Members Account, being, in effect, re-credited to Profit and Loss Account. If book debts are not taken over, any bad debts incurred can be charged to the Provision Account, and the balance, if a debit, taken to Realisation Account, being in respect of debts not reserved for; or if a credit, to Sundry Members Account, being an over-appropriation of profits.

(b) Book-keeping entries for opening the Purchasing Company's books

(1) *Debit* the relevant Asset Accounts with the values at which various assets are acquired; *credit* the Vendor Company's Account with the amount of the purchase consideration and liability accounts with the amounts of any liabilities assumed. Any excess of the sum of the liabilities and the purchase consideration over the aggregate value at which the assets are brought into the books is the amount attributable to goodwill, and should be debited to Goodwill Account. If the assets, less liabilities, exceed the purchase consideration, the difference should be credited to a Capital Reserve Account.

(2) *Debit* the Vendor Company's Account and *credit* Share Capital Account, Cash, etc., with the shares, etc., issued and cash paid, as the case may be, in discharge of the purchase consideration.

(c) Shares issued at a premium valuation

When the purchasing company's shares are issued to the members of the vendor company at a premium, the shares should be brought into the vendor company's books *at their full value* (*i.e.*, including the premium) since the transaction is tantamount to the sale of the undertaking for cash, and the purchase therewith of an investment represented by shares in the purchasing company at the price at which they are issued. In the purchasing company's books the transaction is equivalent to the issue of shares at a premium for cash, and the purchase with the proceeds of the undertaking of the vendor company. As is usual when shares are issued at a premium, only the nominal value of the shares must be credited to Share Capital Account, the premium being credited to a Share Premium Account, which can only be utilised for the purposes stated in Section 56 of the Companies Act, 1948 (*see* p. 214).

(d) Treatment of Revenue Balances

The accumulated revenue balances and reserves of the vendor company should not be brought into the purchasing company's books, since they are not profits of the purchasing company, but are represented by assets which the company purchases and pays for.

Sinking funds for the redemption of liabilities are made up of appropriations of profits and must be treated as such, the assets representing them being taken over. In the vendor company's books all such balances should be transferred to the Sundry Members Account, and will not enter into the purchasing company's books at all. Sinking funds for depreciation of assets, however, are created by *charges* against profits in respect of diminution in the value of the assets, and, as already explained, must be credited to the Realisation Account, or preferably to the relevant assets accounts, before transferring them to Realisation Account. A Capital Redemption Reserve Fund is in the nature of capital, and must be credited to the Sundry Members Account.

Illustration (1)

The Wolverhampton Engineering Company, Limited, is absorbed by the United Engineering Company, Limited, the consideration being the assumption of the liabilities, the discharge of the debenture debt at a premium of 5 per cent., by the issue of 5 per cent. debentures in the United Company, a payment in cash of £3 per share, and the exchange of three £1 shares in the United Company, at an agreed value of £1 10s. 0d. per share, for every share in the Wolverhampton Company.

Close off the books of the Wolverhampton Company, giving both Journal Entries and Ledger Accounts, and show the opening Journal Entries in the books of the United Company.

The following is the Balance Sheet of the Wolverhampton Company at the date of transfer:

WOLVERHAMPTON ENGINEERING COMPANY, LIMITED

Balance Sheet as at 31st December

	£		£
Share Capital - 60,000 £5 Shares fully paid	300,000	Goodwill	25,000
General Reserve Account	32,000	Land and Buildings	76,500
Profit and Loss Account	3,000	Plant and Machinery	220,000
Accident Insurance Fund	5,000	Patents	5,000
5% Debentures	150,000	Patterns and Drawings	2,500
Sundry Creditors	30,000	Work-in-Progress and Stocks-on-Hand ..	106,000
		Sundry Debtors	45,000
		Investments on Compensation Fund Account	5,000
		Cash at Bank and in Hand	35,000
	£520,000		£520,000

WOLVERHAMPTON ENGINEERING COMPANY'S JOURNAL

		£	
Realisation Account	Dr.	520,000	
To Sundry Assets			520,000
Being sundry assets sold to the United Engineering Co. as per Balance Sheet of 31st December.			
Sundry Liabilities	Dr.		
To Realisation Account			30,000
Sundry Creditors		30,000	
Being liabilities taken over by the United Engineering Co.			
Realisation Account	Dr.	7,500	
To Debentures Account			7,500
Being Premium of 5% now provided for.			
United Engineering Co Limited ..		607,500	
To Realisation Account			607,500
Being Purchase Price as per Agreement.			
Sundries—	Dr.		
To United Engineering Co., Ltd.			607,500
Cash		180,000	
Shares (United Engineering Co) ..		270,000	
180,000 Shares of £1 each, fully paid, at £1 10s. per share.			
Debentures Account		157,500	
5% Debentures exchanged.			
Being discharge of Purchase Consideration.			
Sundries—	Dr.		
To Sundry Members Account			
Accident Insurance Fund ..		5,000	
General Reserve Account ..		32,000	
Profit and Loss Account ..		3,000	
Realisation Account – Profit on Transfer		110,000	
Share Capital Account ..		300,000	
Being balances transferred.			
Sundry Members Account	Dr.	450,000	
To Sundries—			
Cash			180,000
United Engineering Co. Shares Account			270,000
Being 3 shares of £1 each valued at £1 10s. per share, and £3 per share in cash for each of 60,000 Shares distributed to Shareholders.			

WOLVERHAMPTON ENGINEERING COMPANY'S LEDGER

REALISATION ACCOUNT

	£		£
To Sundry Assets	520,000	By Sundry Creditors	30,000
,, Premium on Debentures	7,500	,, United Engineering Co., Limited	607,500
,, Sundry Members Account, Profit on absorption	110,000		
	£637,500		£637,500

SUNDRY LIABILITIES

			£
To Realisation Account	30,000	By Sundry Creditors	30,000
	£30,000		£30,000

DEBENTURES

	£		£
To United Engineering Co., Limited	157,500	By Balance b/f.	150,000
		„ Realisation Account – Premium	7,500
	£157,500		£157,500

SUNDRY MEMBERS

	£		£
To Cash	180,000	By Share Capital	300,000
„ United Co.'s Shares	270,000	„ Sundries	150,000
	£450,000		£450,000

SHARES IN UNITED ENGINEERING CO. LTD

	£		£
To United Engineering Co., Limited	270,000	By Sundry Members Account	270,000

ACCIDENT INSURANCE FUND

	£		£
To Sundry Members ..	5,000	By Balance b/f	5,000

GENERAL RESERVE

	£		£
To Sundry Members ..	32,000	By Balance b/f.	32,000

PROFIT AND LOSS ACCOUNT

	£		£
To Sundry Members ..	3,000	By Balance b/f.	3,000

UNITED ENGINEERING COMPANY, LIMITED

	£		£
To Realisation Account	607,500	By Sundries	607,500

UNITED ENGINEERING COMPANY'S JOURNAL

Sundries	*Dr.*		
To Sundries:			
Land and Buildings		76,500	
Plant and Machinery		220,000	
Patents		5,000	
Patterns and Drawings ..		2,500	
Work-in-Progress and Stocks on Hand		106,000	
Sundry Debtors		45,000	
Investments		5,000	
Cash at Bank and in Hand ..		35,000	
Goodwill		142,500	
Wolverhampton Engineering Company, Limited			607,500
Sundry Creditors			30,000
Being Sundry Assets and Liabilities taken over as per Purchase Agreement.			
		£637,500	£637,500

UNITED ENGINEERING COMPANY'S JOURNAL (*continued*)

Wolverhampton Engineering Company, Limited ..	*Dr.*	607,500	
To Sundries:			
Cash			180,000
5% Debentures Account ..			157,500
Share Capital Account—			
180,000 Shares of £1 each			180,000
Share Premium Account ..			90,000
Being discharge of Purchase Consideration, the shares being taken as issued at £1 10s. per share.			
		£607,500	£607,500

Notes to Illustration

(1) ACCIDENT INSURANCE FUND

This fund has been raised by the Wolverhampton Company out of profits, and is represented by specific investments. Since there remains a credit balance on the Fund Account at the date of the sale of the undertaking, it is obvious that the Wolverhampton Company has made a profit to the extent of £5,000 by undertaking their own risks instead of insuring outside. Therefore, although the United Company takes over the investments representing such insurance profits, it only buys them *qua* investments, and should not bring the Fund Account into its books. In the vendor company's books the balance of this Fund Account will be transferred to the Sundry Members Account in common with the other accumulated profit balances.

(2) GOODWILL

The final figure of goodwill, £142,500, shown in the United Company's books, is arrived at by taking the difference between the actual assets acquired and the purchase consideration plus liabilities taken over.

The amount can be proved as follows:

	£
Goodwill as per vendor company's books	25,000
Profit on absorption ditto	110,000
Premium on Debentures unrepresented by assets	7,500
	£142,500

(3) PREMIUM ON SHARES

In the vendor company's books the premium forms part of the cost of the shares in the purchasing company acquired. In effect, therefore, it forms part of the price received for goodwill, since it increases the profit on realisation disclosed by the Realisation Account. In the purchasing company's books, the share premium increases the cost of goodwill. It must be credited to Share Premium Account and can only be dealt with in accordance with the provisions of Section 56 of the Companies Act, 1948.

(e) Where Debtors and Creditors are not taken over

If relief from stamp duty is available under Section 55, Finance Act, 1927, there is no reason why the debtors and creditors should not be taken over by the purchasing company, but where such relief is not available, a considerable saving may result from leaving the debtors to be collected by the new company and the creditors paid by them as agents for the vending company. Where this is done, the liquidation of the vending company cannot be completed until the debts are discharged.

Illustration (2)

Done Ltd.'s summarised Balance Sheet at 31st December was as follows:

	£		£
Issued Capital:		Goodwill ..	3,000
10,000 6% Preference Shares..	10 000	Fixed Assets	22,300
8 000 Ordinary Shares .	8,000	Stock .	4,000
Reserve . . .	2,000	Debtors .	7,000
Profit and Loss Account ..	1,000	Preliminary Expenses	500
5 % Debentures .	12,000	Cash ..	1,200
Creditors .	5,000		
	£38,000		£38,000

A new company, Start Ltd., was formed to acquire (as part of an amalgamation scheme) the business of Done Ltd., which was to be wound up.

Start Ltd. acquired the assets of Done Ltd., with the exception of book debts and cash, but took over no liabilities, agreeing, however, to collect the debts and pay the creditors as agent for Done Ltd.

The purchase consideration was to be satisfied as follows:

(1) To the preference shareholders of Done Ltd. were to be allotted six £1 5% preference shares in Start Ltd. for every five held, and to the ordinary shareholders of Done Ltd., five £1 ordinary shares credited as 18s. paid for every four held.

(2) Sufficient 4% debentures in Start Ltd. to enable the liquidator of Done Ltd. to satisfy the existing debenture holders by new debentures to an extent that would give them a premium of 15%.

The expenses of liquidation were £585.

The Articles of Association of Done Ltd. gave to the preference shares a cumulative preference dividend, any arrears of which were payable on winding-up in priority to return of capital, and a preferential return of capital in a winding-up. 6 months' dividend was payable.

Of the debtors, £200 proved bad, and a discount of $2\frac{1}{2}$% had to be allowed on settlement. Creditors were paid, subject to 4% discount on £2,500. The purchasing company was allowed a commission of $\frac{1}{2}$% on sums collected and $\frac{1}{4}$% on sums disbursed.

Show the ledger accounts necessary to close Done Ltd.'s books, making any necessary calculations to the nearest £.

REALISATION ACCOUNT

	£		£
Goodwill ..	3,000	By Start Ltd , Purchase consideration	34,800
Fixed Assets ..	22,300	,, Discounts received	100
Stock	4,000		
Premium on Debentures .	1,800		
Cash, expenses of liquidation	585		
Bad Debts .. .	200		
Discounts allowed	170		
Start Ltd. – Commission on collection of debts and payment of creditors . ..	45		
Preference Members Account— Arrears of Dividends .. .	300		
Sundry Members Account— Profit on realisation:			
Preference	2,000		
Ordinary	500		
	£34,900		£34,900

SUNDRY MEMBERS

	Preference	Ordinary		Preference	Ordinary
	£	£		£	£
To Preliminary Expenses		500	By Capital	10,000	8,000
,, Shares in Start Ltd.	12,000	9,000	,, Reserve .. .		2,000
,, Cash . ..	300	2,000	,, Profit and Loss Account .		1,000
			,, Profit on Realisation .	2,000	500
			,, Arrears of Dividend .	300	
	£12,300	£11,500		£12,300	£11,500

SUNDRY DEBENTURE HOLDERS

	£		£
To 4% Debentures in Start Ltd.	13,800	By 5% Debentures	12,000
		,, Realisation Account, premium	1,800
	£13,800		£13,800

CASH

	£		£
To Balance b/f.	1,200	By Expenses of Liquidation	585
,, Start Ltd.	1,685	,, Preference Shareholders – Arrears of Dividend	300
		,, Ordinary Shareholders	2,000
	£2,885		£2,885

START LTD.

	£		£
To Realisation Account, purchase consideration	34,800	By 5% £1 Preference Shares in Start Ltd.	12,000
		,, £1 Ordinary Shares in Start Ltd. ..	9,000
		,, 4% Debentures in Start Ltd. ..	13,800
To Sundry Debtors collected ..	6,630	By Sundry Creditors paid .. .	4,900
		,, Realisation Account, Commission— ½% on £6,630 = £33; ¼% on £4,900 = 12	45
		,, Cash	1,685
	£6,630		£6,630

SUNDRY DEBTORS

	£		£
To Balance b/f	7,000	By Realisation Account:	
		Bad Debts .. .	200
		Discounts, 2½% on £6,800	170
		,, Start Ltd. – cash collected .	6,630
	£7,000		£7,000

SUNDRY CREDITORS

	£		£
To Realisation Account –		By Balance b/f.	5,000
Discounts, 4% on £2,500	100		
,, Start Ltd. – amount paid .	4,900		
	£5,000		£5,000

Note

Since the Articles define the rights of the preference shareholders in a winding up, they are entitled to no further share in the assets of the company, and the surplus, after the preference shareholders have received their agreed share of the sale consideration and their arrears of dividend, goes to the ordinary shareholders (*Scottish Insurance Corporation* v. *Wilsons and Clyde Coal Co. Ltd.* (1949), A.C. 462).

§ 18. Reduction of Capital

Section 66, makes provision for the reduction of the share capital of a company as follows:

(1) Subject to confirmation by the court, a company limited by shares, or a company limited by guarantee and having a share capital may, if so authorised by its articles, by special resolution reduce its share capital in any way, and in particular, without prejudice to the generality of the foregoing power, may:

(*a*) extinguish or reduce the liability on any of its shares in respect of share capital not paid up; or

(*b*) either with or without extinguishing or reducing liability on any of its shares, cancel any paid-up share capital which is lost or unrepresented by available assets; or

(*c*) either with or without extinguishing or reducing liability on any of its shares, pay off any paid-up share capital which is in excess of the wants of the company, and may, if and so far as is necessary, alter its memorandum by reducing the amount of its share capital, and of its shares accordingly.

(2) A special resolution under this section is in this Act referred to as 'a resolution for reducing share capital'.

Where the proposed reduction of share capital involves either diminution of liability in respect of unpaid share capital, or the payment to any shareholder of any paid-up share capital, and in any other case if the court so directs, creditors are entitled to object, and those so objecting must be either paid off or secured.

In assenting to a scheme, the principal points the court takes into consideration are the protection of the rights of creditors, and the equitable adjustment of the loss between the various classes of shareholders, having regard to their rights both as to dividend and capital.

The arrangement of a scheme acceptable to all parties and to the court is a matter of much difficulty, and it is not possible here to deal with the subject otherwise than quite generally, since every case must be considered on its merits.

The reduction does not take effect until a copy of the court order and a minute approved by the court have been registered with the registrar of companies. The court may, in its discretion, order the words 'and reduced' to be added to the company's name for a period.

In formulating a scheme of reduction of capital, it is desirable simultaneously to pass a resolution to increase the capital to its original figure by the creation of unissued shares, otherwise, if further shares require to be issued, capital stamp duty will be payable.

(a) Writing off Capital unrepresented by available Assets

The following illustration shows the entries in a company's books to give effect to a reduction of capital where capital has been lost or is unrepresented by available assets.

It is first necessary to create the fund for the reduction by making transfers from the various Share Capital Accounts of the amounts by which the capital is to be reduced and then to apply the fund in writing off the items decided upon. Where drastic alterations in capital are involved, it is preferable to close the old Capital Accounts and open new ones, crediting the difference to the Capital Reduction Account.

Illustration

The summarized Balance Sheet of P. Ltd. at 31st March, 19.., was:

Authorized and Issued Capital:			Goodwill	25,000
100,000 6 per cent Cumulative Preference Shares of £1 each		100,000	Patents and Trade Marks	10,000
200,000 Ordinary Shares of £1 each		200,000	Land and Buildings	88,000
			Plant and Machinery	86,000
		300,000	Shares in Subsidiary Ltd.	30,000
	£		Stock	73,000
5 per cent Debenture (secured on Land and Buildings)	50,000		Debtors	98,500
Add Accrued Interest	2,500		Deferred Expenditure – Advertising	25,000
		52,500	Profit and Loss Account	85,000
Bank Overdraft		60,000		
Creditors		85,000		
Directors' Loans		23,000		
		£520,500		£520,500

Notes: – (1) Dividends on the Preference Shares are three years in arrear.

(2) There is a contingent liability for damages of £10,000.

A Capital Reduction Scheme, duly approved, settled the following terms:

(1) The Preference Shares to be reduced to 16s each and the Ordinary Shares to 5s each and the resulting shares then to be converted into Preference and Ordinary Stock respectively and consolidated into units of £1. The authorized capital to be restored to £100,000 6 per cent Cumulative Preference Stock and £200,000 Ordinary Stock. The Preference shareholders waive two-thirds of the dividend arrears and receive Ordinary Stock for the balance.

(2) All intangible assets to be eliminated, and bad debts of £7,500 and obsolete stock of £10,000 to be written off.

(3) The shares in Subsidiary Ltd. are sold to an outside interest for £60,000.

(4) The Debenture-holder agreed to take over one of the company's properties (book value £18,000) at a price of £25,000 in part satisfaction of the Debenture and to provide further cash of £15,000 on a floating charge. The arrears of interest are paid.

(5) The contingent liability materialized in the sum stated but the company recovered £5,000 of these damages in an action against one of its directors. This was debited to his loan account of £8,000, the balance of which was repaid in cash on his resignation.

(6) The remaining directors agreed to take Ordinary Stock in satisfaction of their loans.

You are required to:

(*a*) Give the necessary Journal entries to record the above, including the cash transactions.

(*b*) Set out the revised Balance Sheet after giving effect to the entries in (*a*).

(Ignore taxation.)

P. LTD.

(*a*) JOURNAL

		£	£
Preference Share Capital Account	*Dr.*	20,000	
Ordinary Share Capital Account		150,000	
To Capital Reduction Account			170,000
Being 4s. per share written off 100,000 6 per cent Cumulative Preference Shares of £1 each and 15s. per share written off 200,000 Ordinary Shares of £1 each, in accordance with Capital Reduction Scheme.			
Preference Share Capital Account	*Dr.*	80,000	
Ordinary Share Capital Account		50,000	
To 6 per cent Cumulative Preference Stock Account			80,000
,, Ordinary Stock Account			50,000
Being conversion of 100,000 Preference Shares of 16s. each and 200,000 Ordinary Shares of 5s. each into stock and consolidation into 80,000 £1 units of 6 per cent Cumulative Preference Stock and 50,000 £1 units of Ordinary Stock respectively.			

P. LTD.

JOURNAL (*continued*)

		£	£
Capital Reduction Account	*Dr*	6,000	
To Ordinary Stock Account			6,000
Being allotment of 6,000 £1 Ordinary Stock units in satisfaction of one-third of the arrears of Preference dividend, the other two-thirds being waived			
Capital Reduction Account	*Dr.*	162,500	
To Goodwill			25,000
„ Patents and Trade Marks			10,000
„ Deferred Expenditure - Advertising			25,000
„ Profit and Loss Account			85,000
„ Debtors			7,500
„ Stock			10,000
Being writing off of intangible assets, bad debts and obsolete stock			
Cash	*Dr*	60,000	
To Shares in Subsidiary Ltd.			30,000
„ Capital Reduction Account			30,000
Being sale of shares in Subsidiary Ltd for £60,000 and excess over book value (£30,000) transferred to Capital Reduction Account.			
5 per cent Debenture	*Dr*	25,000	
To Land and Buildings			18,000
„ Capital Reduction Account			7,000
Being property transferred to debenture-holder at a valuation of £25,000 in part satisfaction of Debenture for £50,000 and excess over book value (£18,000) transferred to Capital Reduction Account			
Debenture Interest	*Dr*	2,500	
To Cash			2,500
Being payment of accrued interest on £50,000 5 per cent Debenture			
Cash	*Dr*	15,000	
To Second Debenture			15,000
Being cash received in respect of a new debenture carrying a floating charge over the assets of the company.			
Capital Reduction Account	*Dr*	5,000	
Directors' Loan Account		5,000	
To Cash			10,000
Being payment of £10,000 in settlement of contingent liability and recovery of £5,000 thereof by set-off against directors' loan			
Directors' Loans	*Dr*	18,000	
To Cash			3,000
„ Ordinary Stock Account			15,000
Being repayment to former director of balance of loan and allotment of Ordinary Stock in satisfaction of other directors' loans			
Capital Reduction Account	*Dr*	33,500	
To Capital Reserve Account			33,500
Being balance on Capital Reduction Account transferred to Capital Reserve.			

P. LTD.

(*b*) BALANCE SHEET AFTER REDUCTION OF CAPITAL

		£		£	£
AUTHORIZED CAPITAL			FIXED ASSETS:		
£100,000 6 per cent Cumulative Preference Stock (£1 units)		100,000	Land and Buildings	70,000	
£200,000 Ordinary Stock (£6 units)		200,000	Plant and Machinery	86,000	
					156,000
		300,000	CURRENT ASSETS		
			Stock	63,000	
			Debtors	91,000	
ISSUED CAPITAL.					154,000
80,000 6 per cent Cumulative Preference Stock (£1 units)		80,000			
71,000 Ordinary Stock (£1 units)		71,000			
		151,000			
CAPITAL RESERVE		33,500			
DEBENTURES.					
5 per cent Debenture (secured)	£25,000				
Second Debenture (secured)	15,000				
		40,000			
CURRENT LIABILITIES:					
Sundry Creditors	85,000				
Bank Overdraft	500				
					£310,000

(b) Other modes of Reduction of Capital

The forfeiture of shares will result in a reduction of capital until such shares are re-issued, but, in view of the circumstances, sanction of the court is not required, the forfeiture being carried out under the terms of the Articles for non-payment of calls or premiums on shares.

The surrender of shares is not valid unless the right of the company to forfeit them has already arisen; nor is the acquisition by a company of its own shares valid, except to the extent that redeemable preference shares can be repaid. The latter is not a reduction, however, inasmuch as, unless there has been a fresh issue of shares for the purpose, the capital is replaced by the Capital Redemption Reserve Fund.

(c) Schemes for Capital Reduction

In *(a)* above, the book-keeping entries required to give effect to a capital reduction scheme have been shown. It is now necessary to consider how a scheme is drawn up, having regard to the facts of the case and the rights of the various classes of persons interested. It must be borne in mind throughout that a scheme for reduction of capital is only worthy of consideration if the company has reasonable prospects of making profits in the future. If it is already a doomed concern, it will be better to wind it up forthwith.

The first step is to determine the amount required to eliminate any fictitious assets, and write down assets that are overvalued. In this connection, it is important to bear in mind that the over-valuation of an asset may result in an excessive charge being made in the Profit and Loss Account for depreciation, causing profits to be understated or losses overstated to the extent of such excess.

Illustration (1)

Plant standing in the books at £100,000, is being depreciated at the rate of 10% per annum, which is considered an adequate rate to eliminate the plant from the books by the end of its effective life. A current valuation on a going concern basis shows that the plant is worth only £40,000. The decrease in the charge for depreciation from £10,000 to £4,000 speaks for itself, and might make all the difference between a profit and a loss or the payment or non-payment of dividends.

Any debit balance on Profit and Loss Account must be provided for, and it is desirable to write off all fictitious assets, *e.g.*, preliminary expenses, to write off or reduce the book value of goodwill and to provide for the adequate writing down of such items as patents, trade marks, patterns, etc., unless they can definitely be deemed to be worth their book values.

Having arrived at the total amount to be provided, it is then necessary to examine closely the rights of the debenture holders, creditors and various classes of share-holders. The following general points must be considered:

(1) *Debenture holders* can sometimes be persuaded to share in the general sacrifices that will be necessary to give the company a new lease of life. Persons who invest in debentures are content with a comparatively low rate of interest, provided their

capital is secured. If it can be shown that on a forced realisation of assets such as would ensue if the company were driven into liquidation, the assets, after providing for preferential creditors and the costs, would not realise sufficient to repay the debentures in full, but that there is every prospect of the security being enhanced in the future if the company is reorganised, then the debenture holders may consent to cooperate by sacrificing some of their capital. Some recompense is usually required, *e.g.*, an increased rate of interest, and/or an interest in the equity by the issue to them of fully-paid ordinary shares for a proportion of their capital contribution to the amount required for writing off assets.

In many cases, it will be found that bankers hold debentures as additional security for loans and overdrafts. These must be taken into consideration, and in very many cases will result in the liability to the bank having to be paid in full.

(2) *Creditors*, other than those who would be preferential in a winding-up, may agree to share in a reduction where the position warrants it. If the debenture holders have agreed to make some sacrifice, the creditors can hardly refrain from doing so, as it can be proved that in the event of liquidation, they would get little or nothing. In other cases, however, creditors can only be expected to accept something less than the amounts due to them where it can be shown that in that way they will get more than if they either refused (making a reconstruction in the circumstances impossible) or forced the company into liquidation.

In most cases, however, neither debenture holders nor creditors can be expected to share in the reduction, and the amount required must be provided by writing down share capital alone.

(3) *Shareholders*. The bulk of the loss, in most cases the whole of it, must fall upon the shareholders. If creditors are to come into the scheme, the shareholders must give up something to them, *e.g.*, a share in the equity that will enable the creditors to reap some reward in future years for their immediate sacrifice.

It is now necessary to consider the position of the various classes of shareholders.

Where capital has been lost, the brunt of the loss must fall on the ordinary shareholders, but if this would mean their losing all their interest in the company it is obvious that they would not agree to the scheme. The company may have retained in the past profits which could have been distributed as dividends, but which the shareholders allowed to remain in order to strengthen the company's finances. As the company fell on leaner times such reserves may have been drawn upon to pay preference dividends, with the result that the ordinary shareholders have already made a sacrifice for the benefit of the preference shareholders.

Before considering this question further, it is essential to appreciate the real effect of writing down capital. As an example, let it be assumed that the capital of a company is £100,000, divided into 60,000 £1 6% preference shares and 40,000 £1 ordinary shares. So far as profits are concerned, whatever sum remains after the

preference dividend of £3,600 has been paid is divisible among the ordinary shareholders. It does not matter, therefore, to what nominal value the ordinary shares are written down; the *amount* of the dividend per share remains the same, though the rate per cent. is increased, and the market value of the shares will not be affected by the reduction in nominal value. Writing down ordinary shares therefore entails no real sacrifice so long as the shareholders' interest in the divisible profits is not reduced. A reduction in the nominal value of the preference shares, however, or in the rate of dividend payable thereon, will reduce the preference shareholders' participation in profits and, as a consequence, the market value of their shares. Again, if the preference shares have the right to preferential repayment of capital, but are entitled to no right to share in a surplus on a winding-up, the ordinary shareholders will receive all the assets remaining after repaying the preference capital, no matter what the nominal value of the ordinary shares may be. Writing down ordinary shares in such circumstances imposes no sacrifice upon the holders of such shares.

Where preference shareholders are entitled to share in a surplus the writing down of the ordinary shares does involve a sacrifice of rights, since a bigger proportion of any surplus would then go to the preference shareholders. The ultimate winding-up rights, however, are not so immediately important as the dividend, *i.e.*, going concern rights, and, therefore, where preference shareholders are called upon to share in a reduction of capital it is only equitable that ordinary shareholders should give up part of their rights to the preference shareholders.

It is considered that preference shareholders should only be asked to share in a reduction where their dividend rights are excessive, having regard to current conditions, and/or the amount required exceeds the ordinary capital. In such cases the preference shareholders might be asked to accept a lower rate of dividend or make some contribution to the loss of capital, but in either case they should receive some compensation such as a share in the equity of the company to give them the chance of recouping at least part of their loss if conditions improve.

Arrears of cumulative preference dividends must be dealt with on their merits. If they are cancelled, the preference shareholders should be compensated by the issue to them of shares or income certificates (to be paid off out of future profits in priority to dividends) in respect of the whole or part of the arrears, the cancellation of which will benefit the ordinary shareholders.

The real test of whether the scheme is reasonably equitable is to compute how the estimated future income will be divisible under the new share capital holdings as compared with the old, bearing in mind that, as a result of the reorganisation, all classes of shares can anticipate immediate dividends instead of waiting until the debit balance on Profit and Loss Account is eliminated by profits. The benefit of immediate dividends is greater, the lower the class of shares. Deferred shares, as a rule, will have to be cancelled, or given a very minute interest in the reorganised company. If, however, they hold valuable rights *pari passu* with the ordinary shares, they will have to rank equitably with the latter.

Illustration (2)

The following is the Balance Sheet of Mills Ltd. as on 31st December:

	£		£
Capital, Authorised and Issued:		Goodwill	100,000
250,000 6 per cent. Cumulative Preference Shares of £1 each	250,000	Patents and Trade Marks	80,000
250,000 Ordinary Shares of £1 each	250,000	Freehold Land and Buildings	135,000
6 per cent. Debentures secured by a floating charge on the assets	100,000	Plant and Machinery ..	85,000
Arrears of Interest thereon ..	12,000	Stock-in-Trade	79,900
Sundry Creditors	64,000	Sundry Debtors	110,000
Bank Overdraft	24,000	Cash in hand	100
		Profit and Loss Account	110,000
	£700,000		£700,000

The dividends on the preference shares are 5 years in arrear.

The directors state that the current trading results show a marked improvement, and that they anticipate a net profit of £20,000 per annum will be maintained in future years.

They desire to resume the payment of dividends as soon as possible and are accordingly considering the reduction of the company's capital.

The debenture holders, in order to assist in the revival of the company, have expressed their willingness to exchange their arrears of interest for an interest in the equity of the business of one-half of the nominal value of the arrears, and to provide £25,000 further cash (on a floating charge) to repay the bank overdraft and to provide working capital of £1,000.

The preference shares are described by the Articles as not preferential as to capital, but any arrears of dividends are to form a first charge upon any surplus on winding-up. The preference shareholders have expressed their willingness to a reduction in the rate of dividend to 5 per cent. and to forego two-thirds of their arrears, provided that they receive an interest in the equity equal in nominal value to the remaining third.

You are required:

(*a*) To draft a scheme for the reduction of capital which should include the elimination of goodwill (acquired from James Mill on the formation of the company in exchange for 100,000 ordinary shares which he still holds) and the Profit and Loss Account balance, the reduction of the value of patents and trade marks by £50,000, and the provision of a capital reserve through which any adjustments arising out of the capital rearrangements, etc., may be dealt with. After reduction, the ordinary shares are to be converted into shilling shares.

(*b*) To re-draft the Balance Sheet, giving effect to the scheme you suggest.

(*a*) *Scheme for Reduction of Capital*

The amount by which the capital is to be reduced is £285,000, made up as follows:

	£
To eliminate Goodwill	100,000
„ „ Profit and Loss Account balance	110,000
„ write down Patents and Trade Marks	50,000
„ provide for one-third of arrears of Preference Dividend	25,000
	£285,000

Since the preference shares are not entitled to priority as to capital, the loss of capital should, *primâ facie*, be borne equally between the ordinary and the preference shareholders. In view, however, of the fact that the preference shareholders have consented to a reduction in their rate of cumulative dividend to 5 per cent., which, of itself, will reduce the value of their shares, they should be required to suffer a correspondingly smaller reduction in their nominal capital. It is true that the preference shareholders are also to receive a share in the equity amounting to £25,000, but this is in consideration of the cancellation of £75,000 arrears of dividend, and is quite independent of the reduction in nominal capital.

It is therefore proposed that the capital be reorganised as follows:

		£
(1) The 250,000 6 per cent. cumulative preference shares of £1 each to be reduced to shares of 13s. 6d. each, and subdivided into:		
250,000 5 per cent. cumulative preference shares of 10s. each ..	£125,000	
875,000 ordinary shares of 1s. each	43,750	
	£168,750	
This represents a reduction in capital of		81,250
In addition, the preference shareholders to receive 500,000 ordinary shares of 1s. each = £25,000, in satisfaction of one-third of their arrears of dividend, the balance to be cancelled.		
(2) The 250,000 ordinary shares of £1 each to be reduced to shares of 4s. each, and converted into 1,000,000 ordinary shares of 1s. each		
This represents a reduction in capital of		200,000
(3) The debenture holders to be alloted 120,000 ordinary shares of 1s. each in satisfaction of half their arrears of interest, the balance to be cancelled.		
This represents a reduction of		6,000
Total reduction		£287,250

Of this amount, £285,000 will be applied in writing down the assets and providing for the £25,000 arrears of preference dividend, as shown above. The balance of £2,250 may be applied in meeting the costs of the reduction scheme and any adjustments arising out of it, and in reducing such other of the assets as may be determined by the directors.

The paid-up capital of the company will now consist of:

250,000 5 per cent. cumulative preference shares of 10s. each	£125,000
2,495,000 ordinary shares of 1s. each	124,750
	£249,750

The resolution for reduction of capital should at the same time provide for the restoration of the authorised capital to £500,000, thus leaving £250,250 unissued capital, which would be available for issue at some future date, if required.

The effect of the above reorganisation of capital, assuming an annual profit of £20,000 to be maintained, will be to cause the profits to be divided between the existing preference and ordinary shareholders in approximately the following proportions. Although on a profit of £20,000, the preference shareholders will receive a little less than previously, their holding of ordinary shares will give them the control of the company, and they will take a major share in any increase in distributable profits over £20,000.

	£	£
Existing preference shareholders will receive:		
Dividend of 5 per cent. on £125,000 new preference shares	6,250	
Dividend of, say, 10 per cent. on £68,750 new ordinary shares	6,875	
		13,125
Existing ordinary shareholders will receive:		
Dividend of, say, 10 per cent. on £50,000 new ordinary shares		5,000
Debenture holders will receive:		
Dividend of, say, 10 per cent. on £6,000 new ordinary shares		600
		18,725
Carry forward		1,275
		£20,000

Note

It is assumed that the debenture interest would already have been provided for before arriving at the profit of £20,000.

MILLS LTD
RE-DRAFTED BALANCE SHEET

Capital—			FIXED ASSETS—		
Authorised	500,000		Patents and Trade Marks	30,000	
			Freehold Land and Buildings ..	135,000	
Issued—			Plant and Machinery .. .	85,000	
250,000 5% Cumulative Preference Shares of 10s. each .. .	125,000				250,000
2,495,000 Ordinary Shares of 1s. each	124,750		CURRENT ASSETS—		
		249,750	Stock-in-Trade . ..	79,900	
Capital Reserve		2,250	Sundry Debtors	110,000	
6% Debentures secured by a floating charge on the assets		125,000	Cash	1,100	
Sundry Creditors		64,000			191,000
		£441,000			£441,000

§ 19. Reconstructions and Reorganisations

The sale of the undertaking of an existing company to a new company specially formed for that purpose is termed a reconstruction, and may be resorted to for any of the following objects:

(1) For the purpose of raising fresh capital by issuing partly paid shares in the new company in exchange for fully paid shares in the old company, and calling up the balance of such new shares as and when required.

(2) For amalgamating two or more companies.

(3) For taking new powers in the Memorandum, or changing the domicil of the company.

(4) For re-arranging the capital and the rights of members as between themselves.

(5) For effecting a compromise with creditors, or the allotment to them of shares or debentures in settlement of their claims.

The cases of amalgamation and absorption of one company by another have already been dealt with.

Where a company is being wound up voluntarily, and is disposing of the whole or part of its undertaking to another company in consideration for shares in that company, to be distributed rateably amongst the shareholders of the vendor company, the scheme must be approved by the members by special resolution (in the case of a creditors' winding-up, with the sanction of the committee of inspection or of the court). Any dissentient member may call upon the liquidator by notice in writing within 7 days of the date of the resolution, either to abandon the scheme, or purchase the dissentient's interest at a price to be agreed or settled by arbitration. This course might be adopted where the shares of the new company are to be allotted as only partly paid.

If the liquidator elects to purchase the member's interest, the purchase money must be paid before the company is dissolved, and be raised by the liquidator in such manner as may be determined by special resolution (§ 287).

It may be arranged for the shares not taken up by shareholders to be allotted to the nominee of the liquidator, who will sell them for the best price he can obtain, and divide the proceeds among the shareholders who dissent from the scheme.

In cases where a company has sustained a considerable loss of capital and is unable to satisfy its creditors in full, the reconstruction scheme commonly provides for a reduction of the original capital, a compromise with the creditors either for cash or for the issue of fully-paid shares or debentures, and the provision of new working capital by the issue to the existing shareholders of partly paid up shares, in exchange for the shares held in the old company.

Illustration

The final Trial Balance of the Patent Bottle Company, Limited, was as follows:

	£	
Share Capital:		
50,000 Shares of £1 each fully paid		50,000
Creditors		26,500
Patent Rights	48,000	
Debtors	4,500	
Stock	10,000	
Preliminary Expenses	1,800	
Profit and Loss Account	12,050	
Cash	150	
	£76,500	£76,500

Efforts to secure sufficient new capital to pay off the liabilities and place the concern on a sound basis having proved unsuccessful, it was decided to reconstruct, and the following scheme was submitted to, and approved by, the shareholders and creditors:

(1) The company to go into voluntary liquidation, and a new company having a nominal capital of £100,000 to be formed, called the New Patent Bottle Company, Limited, to take over the assets and liabilities of the old company.

(2) The assets to be taken over at book value, with the exception of the patent rights, which were to be subject to adjustment.

(3) The creditors to be discharged by the new company on the following basis:

	£
Preferential creditors to be paid in full	500
Unsecured creditors to be discharged by cash composition of 10s. in the £ ..	13,400
Unsecured creditors to be discharged by issue of 6 per cent. debentures fully paid at a bonus of 10 per cent.	12,600
	£26,500

(4) 50,000 shares of £1 each, 10s. paid up, to be issued to the shareholders in the old company, payable 5s. on application and 5s. on allotment.

(5) The costs of liquidation amounting to £250 to be paid by the new company as part of the purchase consideration.

Close the books of the old company, and show the opening entries in the new company's books, preparing therefrom a Balance Sheet, assuming all the shares and debentures to have been allotted, and all cash in respect of the shares to have been received.

OLD COMPANY'S BOOKS
JOURNAL

			£	£
Realisation Account			62,650	
To Sundry Debit Balances (as per Trial Balance)				62,650
Being Sundry Assets transferred.				
Realisation Account			1,260	
To Sundry Creditors				1,260
Being Bonus of 10% on £12,600, payable in 6% Debentures fully paid, as per agreement				
Purchasing Company	Dr.		46,310	
To Realisation Account				46,310
Being Purchase consideration payable under scheme as follows:				
50,000 Shares of £1 each, 10s. paid up, to be issued to Shareholders		£25,000		
£13,860 6% Debentures fully paid, to be issued to Creditors in part payment		13,860		
Cash to Creditors in part payment of Unsecured Creditors and in full discharge of Preferential Creditors ..		7,200		
Cash for Liquidation Expenses		250		
		£46,310		
Realisation Account	Dr.		250	
To Cash				
Being payment of Liquidation Expenses				
Sundries—	Dr.			
To Purchasing Company				46,310
Shares Account 50,000 Shares of £1 each, 10s. paid up			25,000	
Debentures Account £13,860 6% Debentures			13,860	
Cash			7,450	
			£46,310	£46,310
Being assets handed over by New Company to Liquidator in settlement of Purchase consideration				
Sundry Creditors	Dr.		27,760	
To Sundries—				
Debentures				13,860
Cash				7,200
Realisation Account				6,700
			£27,760	£27,760
Being discharge of amounts due to Sundry Creditors as per agreement, and transfer of balance to Realisation Account.				
Sundry Members ..	Dr.		11,150	
To Realisation Account ..				11,150
Being loss on Realisation.				
Sundry Members ..	Dr.		13,850	
To Sundries—				
Profit and Loss Account				12,050
Preliminary Expenses				1,800
Being Balances Transferred.				
Share Capital			50,000	
To Sundry Members Account				50,000
Being Share Capital Transferred				
Sundry Members	Dr.		25,000	
To Shares in New Company				25,000
Being issue of 50,000 Shares £1 each, 10s. paid up in New Company in exchange for Shares in Old Company.				

LEDGER
REALISATION ACCOUNT

	£		£
To Sundry Assets ..	62,650	By Purchasing Company	46,310
„ Creditors 10% Bonus	1,260	„ Sundry Creditors. Rebate allowed ..	6,700
„ Cash – Expenses ..	250	„ Sundry Members Account, being Loss	11,150
	£64,160		£64,160

PURCHASING COMPANY

To Realisation Account	46,310	By Sundries ..	46,310

SUNDRY CREDITORS

To Debentures in New Company	13,860	By Balance b/f. ..	26,500
„ Cash	7,200	„ Realisation Account	1,260
„ Realisation Account ..	6,700		
	£27,760		£27,760

SUNDRY MEMBERS

			£
To Realisation Account, Loss	11,150	By Share Capital Account	50,000
„ Profit and Loss Account	12,050		
„ Preliminary Expenses	1,800		
„ Shares in New Company	25,000		
	£50,000		

CASH BOOK

	£		£
To Purchasing Company	7,450	By Sundry Creditors ..	7,200
		„ Liquidation Expenses	250
	£7,450		£7 450

NEW COMPANY'S BOOKS
JOURNAL

		£	£
Sundry Assets—			
To Vendor ..			46,310
Patent Rights		31,660	
Debtors ..		4,500	
Stock ..		10,000	
Cash ..		150	
		£46,310	£46,310
Being assets taken over in accordance with Scheme of Reconstruction.			
Vendor	*Dr.*	46,310	
To Sundries—			
Share Capital Account – 50,000 Shares of £1 each, 10s. paid up			25,000
6% Debentures			13,860
Cash			7,450
		£46,310	£46 310
Being Shares and Debentures issued and Cash paid in settlement of purchase consideration.			
Application and Allotment Account	*Dr.*	25,000	
To Share Capital			25,000
Being 5s. per Share payable on application and 5s. on allotment of 50,000 Shares issued.			

CASH BOOK

	£		£
To Vendor ..	150	By Vendor ..	7,450
" Application	12,500	" Balance c/d.	17,700
" Allotment	12,500		
	£25,150		£25,150
To Balance b/d.	17,700		

BALANCE SHEET AS AT...........

	£		£
		Patent Rights at cost .	31,660
Nominal Capital:		Debtors .. .	4,500
100,000 Shares £1 each ..	100,000	Stock .. .	10,000
		Cash .. .	17,700
Issued Capital:			
50,000 Shares £1 each, fully paid	50,000		
6% Debentures	13,860		
	£63,860		£63,860

Notes

(*a*) Payment of Creditors

As the liquidator is responsible to the creditors of the old company to see that the conditions as set forth in the scheme of reconstruction are duly carried out, the liabilities will be discharged through him, and the transactions will consequently be recorded in the books of the old company.

(*b*) The Adjusted Value of the Patent Rights

The value placed upon the patent rights is arrived at by taking the difference between the purchase price payable to the vendor and the assets taken over upon which an agreed value was placed. The debit balance to Profit and Loss Account and the preliminary expenses as shown in the Trial Balance of the old company are, of course, ignored in the books of the new company.

£
7,200
250

CHAPTER IX

THE ACCOUNTS OF HOLDING COMPANIES

§ 1. Holding Companies

In addition to carrying on their ordinary functions as trading concerns, many companies invest a substantial proportion of their capital in the purchase of shares in subsidiary companies with a view to controlling their operations. In some instances the whole of the share capital of the holding company is employed in this way and no trading operations are carried on direct. Control of the subsidiary companies is secured by acquiring a majority of the shares carrying voting rights, and thus the holding company is in a position to control the composition of the board of directors of the subsidiary.

The holding company system has many advantages, of which the following may be mentioned:

(1) Where it is desired to amalgamate a number of businesses, and at the same time to preserve their separate identities and goodwills, a holding company is an obvious solution.

(2) Where it is desired to decentralise an existing business, subsidiary companies may be formed to take over certain of its branches or activities.

(3) Another aspect of preserving the separate entities of businesses is that thereby the income tax assessments on the respective businesses are not disturbed. (This, however, is not now such an important consideration, since by Section 17, Finance Act, 1954, the preceding year basis of assessment will continue to apply even on a complete amalgamation where a company is the vendor of the business and at any time within 2 years after the change at least 75 per cent. of the trade belongs to the same persons as at some time within one year before the change.)

(4) If it is desired to discontinue certain of the operations, only the subsidiary company or companies carrying on those operations need be closed down or the interest therein sold, whereas if all the businesses are merged into one, the discontinuance of part might be much more difficult and disturbing.

(5) Since each company must prepare separate accounts, the separate results of each business are available, whereas in a single concern there might be a temptation to dispense with the necessary analysis required to ascertain departmental results.

(6) Most of the advantages of complete amalgamation apply equally to the holding company type of merger.

Where one company desires to obtain a controlling interest in another company, shares therein can either be acquired by purchase in the open market, or an offer can be made to its shareholders through its directors. In either case the purchasing company may not be able to acquire the whole of the shares, and in many instances the

acquisition of a majority of the shares carrying the voting rights is all that is considered necessary. In some instances, however, it may be desired to obtain a complete interest, and this is rendered possible under Section 209 of the Companies Act, 1948.

This section provides that where a scheme or contract involving the transfer of shares has, within 4 months after the making of the offer, been approved by the holders of not less than nine-tenths in value of the shares affected (other than shares already held by the transferee company or its nominee), the transferee company may, at any time within 2 months after the expiration of the said 4 months, give notice in the prescribed manner to any dissentient shareholder that it desires to acquire his shares. It is then entitled and bound to acquire those shares on the same terms as those on which the other shares are to be transferred, unless the court, upon the application of the dissentient shareholder, within one month of the date of the notice orders otherwise.

Where, however, the transferee company already holds shares in the transferor company of the same class as the shares whose transfer is involved, to a value greater than one-tenth of the aggregate value of the shares whose transfer is involved (other than those already held by the transferee company), the foregoing provisions shall not apply unless:

(*a*) the transferee company offers the same terms to a holders of the shares whose transfer is involved; and

(*b*) the holders who approve the scheme or contract, besides holding not less than nine-tenths in value of the said shares (other than those already held) represent not less than 75 per cent. of the holders of those shares (§ 209 (1)).

Where, in pursuance of any such scheme or contract, shares in a company are transferred to another company or its nominee, and those shares, together with any other such shares already held by the transferee company or its subsidiary, comprise or include nine-tenths in value of the shares in the first mentioned company, or of any class thereof, the transferee company must, within one month from the date of the transfer, give notice of that fact in the prescribed manner to the holders of the remaining shares who have not assented to the scheme. Any such holder may then, within three months, require the transferee company to acquire his shares, and the transferee company shall then be entitled and bound to acquire those shares on the same terms as those under which the shares of the approving shareholders were transferred to it, or on such other terms as may be agreed or as the court thinks fit to order (§ 209 (2)).

Where a notice has been given under Section 209 (1), and the court has not, upon application, seen fit to interfere, the transferee company shall at the expiration of one month from the date of the notice, or upon the disposal of the application to the court, transmit a copy of the notice to the transferor company together with an intrument of transfer duly executed, and pay the amount of the consideration for the shares to be acquired, and the transferee company shall then be registered as the holder of the shares in question.

The consideration shall be paid into a separate bank account, to be held on trust for the shareholders entitled thereto, who can presumably obtain it upon surrender of their share certificates (§ 209 (3)).

§ 2. Definition of Subsidiary Company

Section 154 of the Companies Act, 1948, defines a subsidiary company as follows:

(1) For the purposes of this Act, a company shall, subject to the provisions of subsection (3) of this section, be deemed to be a subsidiary of another if, but only if,:

(*a*) that other either:

(i) is a member of it and controls the composition of its board of directors; or

(ii) holds more than half in nominal value of its equity share capital; or

(*b*) the first-mentioned company is a subsidiary of any company which is that other's subsidiary.

(2) For the purposes of the foregoing subsection, the composition of a company's board of directors shall be deemed to be controlled by another company if, but only if, that other company by the exercise of some power exercisable by it without the consent or concurrence of any other person can appoint or remove the holders of all or a majority of the directorships; but for the purposes of this provision that other company shall be deemed to have power to appoint to a directorship with respect to which any of the following conditions is satisfied, that is to say:

(*a*) that a person cannot be appointed thereto without the exercise in his favour by that other company of such a power as aforesaid; or

(*b*) that a person's appointment thereto follows necessarily from his appointment as director of that other company; or

(*c*) that the directorship is held by that other company itself or by a subsidiary of it.

(3) In determining whether one company is a subsidiary of another:

(*a*) any shares held or power exercisable by that other in a fiduciary capacity shall be treated as not held or exercisable by it;

(*b*) subject to the two following paragraphs, any shares held or power exercisable:

(i) by any person as a nominee for that other (except where that other is concerned only in a fiduciary capacity); or

(ii) by, or by a nominee for, a subsidiary of that other, not being a subsidiary which is concerned only in a fiduciary capacity;

shall be treated as held or exercisable by that other;

(*c*) any shares held or power exercisable by any person by virtue of the provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded;

(*d*) any shares held or power exercisable by, or by a nominee for, that other or its subsidiary (not being held or exercisable as mentioned in the last foregoing paragraph) shall be treated as not held or exercisable by that other if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

(4) For the purposes of this Act, a company shall be deemed to be another's holding company if, but only if, that other is its subsidiary.

(5) In this section the expression 'company' includes any body corporate, and the expression 'equity share capital' means, in relation to a company, its issued share capital

excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.

From the above definition it will be seen that for A Ltd. to be a subsidiary of B Ltd.:

(*a*) B Ltd. must *both* hold shares in, *and* control the composition of the board of directors of A Ltd. in the manner defined in the Act; *or*

(*b*) B Ltd. must hold more than half in nominal value of the equity share capital of A Ltd.; *or*

(*c*) A Ltd. must be a subsidiary of another company which itself is a subsidiary of B Ltd.

In determining whether B Ltd. holds more than half of the equity share capital of A Ltd., any shares in A Ltd. held by a nominee or subsidiary of B Ltd. will be deemed to be held by B Ltd.

The definition of 'equity share capital' for the above purpose given in subsection (5) merits attention. The expression means all the issued capital, except any part thereof which, *neither* as respects dividends *nor* as respects capital, carries any right to participate beyond a specified amount in a distribution. Thus it would appear that preference shares which carry the right to a fixed rate of dividend and to no further participation in profits, but which are entitled, on a winding-up, to participate beyond a fixed amount in any surplus assets remaining after the share capital has been repaid, would be regarded as part of the equity share capital for this purpose.

A body corporate or its nominee cannot be a member of a company which is its holding company, and any allotment or transfer of shares in a company to its subsidiary is void, except as follows:

(*a*) Where the subsidiary is concerned as personal representative or as trustee (unless the holding company or a subsidiary thereof is beneficially interested under the trust and is not so interested merely by way of security for money lent in the ordinary course of a business which includes lending money);

(*b*) Where a subsidiary was a member of its holding company at 1st July 1948 it may continue to be a member, but shall have no right to vote at any meeting of the holding company or any class of members thereof (§ 27).

A distinction must be drawn between a subsidiary company and an associated company. The latter is one working in close association with, and possibly with common directors, without actually being a subsidiary of, the holding company.

§ 3. Group Accounts

Where at the end of its financial year a company has subsidiaries, accounts or statements (referred to as 'group accounts') dealing with the state of affairs and profit or loss of the company and the subsidiaries must be laid before the company in general meeting when the company's own Balance Sheet and Profit and Loss Account are so laid, except that:

(*a*) group accounts are not required where the company is at the end of its financial year the wholly owned subsidiary of another body corporate incorporated in Great Britain. A wholly owned subsidiary is one which has no members other than its

holding company and that holding company's wholly owned subsidiaries and its or their nominees; and

(*b*) group accounts need not deal with a subsidiary of the company if the company's directors are of opinion that:

(i) it is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or

(ii) the result would be misleading, or harmful to the business of the company or any of its subsidiaries; or

(iii) the business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking;

and, if the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required.

It is, however, provided that the approval of the Board of Trade shall be required for not dealing in group accounts with a subsidiary on the ground that the result would be harmful, or on the ground of the difference between the business of the holding company and that of the subsidiary (§ 150).

The group accounts laid before a holding company must be consolidated accounts comprising:

(*a*) a consolidated Balance Sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;

(*b*) a consolidated Profit and Loss Account dealing with the profit or loss of the company and those subsidiaries.

If, however, the company's directors are of opinion that it is better for the purpose of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries, so that it may be readily appreciated by the company's members, the group accounts may be prepared in some other form. In particular they may consist of more than one set of consolidated accounts, dealing respectively with the company and one group of subsidiaries, and with other groups of subsidiaries, or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

The group accounts may be wholly or partly incorporated in the company's own Balance Sheet and Profit and Loss Account (§ 151).

The following are some of the forms of group accounts, other than the conventional consolidated Balance Sheet and Profit and Loss Account, which are met with in practice:

(i) Consolidated statements of assets and earnings of some or all of the subsidiaries. In some cases the earnings of all the companies in the group are consolidated, but separate statements are submitted with regard to the net assets of some or all of the subsidiaries. This method may be useful where the parent company has substantial interests in foreign companies and exchange restrictions are in operation.

(ii) The separate Balance Sheets and Profit and Loss Accounts of subsidiaries, amplified by such notes as are necessary, are submitted as exhibits to the holding company's own accounts. This method may be useful where a company has only one or two subsidiaries, or has a subsidiary whose business is entirely different from that of the holding company and its other subsidiaries.

(iii) The insertion of notes in the separate accounts of the holding company, or in the consolidated accounts.

In some cases the consolidated figures are shown in columns provided in the holding company's own accounts, any necessary additional information being given by way of notes.

The group accounts must give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the holding company.

Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts must, unless the Board of Trade, on the application or with the consent of the holding company's directors otherwise direct, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.

If prepared as consolidated accounts, the group accounts must comply with the requirements of the Eighth Schedule to the Act (*see post*), so far as applicable thereto, and if not so prepared must give the same or equivalent information. The Board of Trade may, however, on the application or with the consent of a company's directors, modify the said requirements for the purpose of adapting them to the circumstances of the company (§ 152).

A holding company's directors must secure that except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year (§ 153 (1)).

Where it appears to the Board of Trade desirable for a holding company or a holding company's subsidiary to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting from one calendar year to the next, the Board may on the application or with the consent of the directors of the company whose financial year is to be extended direct that, in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting or the making of an annual return shall not be required in the earlier of the said calendar years (§ 153 (2)).

The special provisions contained in the EIGHTH SCHEDULE, PART II where the company is a holding or subsidiary company are as follows:

Modifications of and Additions to Requirements as to Company's own Accounts

15. (1) This paragraph shall apply where the company is a holding company, whether or not it is itself a subsidiary of another body corporate:

(2) The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the Balance Sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and:

(*a*) the references in Part I of the 8th Schedule (*see* p. 280) to the company's investments shall not include investments in its subsidiaries, required by this paragraph to be separately set out; and

(*b*) The requirements of paragraph 5, and paragraph (1) (*a*), and sub paragraph (2) of paragraph 14 of this Schedule (as to showing the cost or valuation, amounts written off for depreciation, etc.), shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries.

(3) There must be shown by way of note on the Balance Sheet or in a statement or report annexed thereto the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees, but excluding any of those shares or debentures in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(4) WHERE GROUP ACCOUNTS ARE NOT SUBMITTED, there shall be annexed to the Balance Sheet a statement showing—

(*a*) the reasons why subsidiaries are not dealt with in group accounts;

(*b*) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa):

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their previous financial years since they respectively became the holding company's subsidiary;

(*c*) the net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa):

(i) for the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) for their other financial years since they respectively became the holding company's subsidiary;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts;

(*d*) any qualifications contained in the report of the auditors of the subsidiaries on their accounts for their respective financial years ending as aforesaid, and any note or saving contained in those accounts to call attention to a matter which, apart from the note or saving, would properly have been referred to in such a qualification, in so far as the matter which is the subject of the qualification or note is not covered by the company's own accounts and is material from the point of view of its members;

or, in so far as the information required by this sub-paragraph is not obtainable, a statement that it is not obtainable:

Provided that the Board of Trade may, on the application or with the consent of the company's directors, direct that in relation to any subsidiary this sub-paragraph shall not apply only to such extent as may be provided by the direction.

(5) Paragraphs (*b*) and (*c*) of the last foregoing sub-paragraph shall apply only to profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where:

(*a*) the company is itself the subsidiary of another body corporate; and

(*b*) the shares were acquired from that body corporate or a subsidiary of it;

and for the purposes of determining whether any profits or losses are to be treated as profits or losses for the said period the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(6) WHERE GROUP ACCOUNTS ARE NOT SUBMITTED, there shall be annexed to the Balance Sheet a statement showing, in relation to the subsidiaries (if any) whose financial years did not end with that of the company:

(*a*) the reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and

(*b*) the dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates.

16. The Balance Sheet of a company which is a subsidiary of another body corporate, whether or not it is itself a holding company, shall show the aggregate amount of its indebtedness to all bodies corporate of which it is a subsidiary or a fellow subsidiary and the aggregate amount of the indebtedness of all such bodies corporate to it, distinguishing in each case between indebtedness in respect of debentures and otherwise.

For the purposes of this paragraph a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.

Consolidated Accounts of Holding Company and Subsidiaries

17. Subject to the following paragraphs of this Part of this Schedule, the consolidated Balance Sheet and Profit and Loss Account shall combine the information contained in the separate Balance Sheets and Profit and Loss Accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.

18. Subject as aforesaid and to Part III of this Schedule, the consolidated accounts shall, in giving the said information, comply, so far as practicable, with the requirements of this Act as if they were the accounts of an actual company.

19. Sections 196 and 197 of this Act (which deal with the disclosure of payments to directors) shall not, by virtue of the two last foregoing paragraphs, apply for the purpose of the consolidated accounts.

20. Paragraph 7 of this Schedule (dealing with movements of reserves and provisions) shall not apply for the purpose of any consolidated accounts laid before a company with the first balance sheet so laid after the commencement of this Act.

21. In relation to any subsidiaries of the holding company not dealt with by the consolidated accounts:

(*a*) sub-paragraphs (2) and (3) of paragraph 15 of this Schedule shall apply for the purpose of those accounts as if those accounts were the accounts of an actual company of which they were subsidiaries; and

(*b*) there shall be annexed the like statement as is required by sub-paragraph (4) of that paragraph where there are no group accounts, but as if references therein to the holding company's accounts were references to the consolidated accounts.

22. In relation to any subsidiaries (whether or not dealt with by the consolidated accounts) whose financial years did not end with that of the company, there shall be annexed the like statement as is required by sub-paragraph (6) of paragraph 15 of this Schedule where there are no group accounts.

In connection with the statement as to profits and losses of subsidiary companies required by the Act to be annexed to the Balance Sheet of the holding company where group accounts are not submitted, in the opinion of counsel obtained by the Institute of Chartered Accountants the term 'profits' in paragraph 15 (4) (*b*) and (*c*) only includes profits of a subsidiary which are or might have been distributed so as to become revenue profits in the hands of the holding company *in the year to which the holding company's accounts relate;* they do not include profits which have been distributed in past years, which to the extent that they had been received by the holding company would have been dealt with in the previous accounts of that company. In view of the above opinion the Council of the Institute of Chartered Accountants communicated with the Board of Trade, who authorised it to state that no exception will be taken by the Board to the following information being disclosed in the statement:

(*a*) the amount of the profits less losses (or vice versa) of subsidiaries which has neither been dealt with in the holding company's accounts of the year, nor in the accounts of any prior year; and

(*b*) the amount of profits less losses (or vice versa) dealt with in the holding company's accounts of the year, subdivided to distinguish the amounts derived respectively from current and other results of the subsidiaries dealt with.

Where, for example, two wholly-owned subsidiaries acquired by a company on 1st January, 1956, made a net aggregate profit (after deducting taxation) of £15,000 in each of the years 1956, 1957 and 1958, and distributed £5,000 (net) in each year between them, and retained as a revenue reserve £10,000 in each year, the statement recommended by the Council of the Institute is in the following form:

	Profits in respect of financial years of subsidiaries		
	ending in 1958	*other years*	*Total*
			£
The net aggregate amount of the profits *less losses* of the subsidiaries *so far as it concerns the members of this company*:			
(i) dealt with in this company's accounts for the year 1958, amounted (gross) to	8,696		8,696
Less income tax	3,696		3,696
	5,000		5,000
(ii) not dealt with in this company's accounts for the year 1958 amounted, after charging taxation to ..	10,000	20,000	30,000

Alternatively, the required information may be given by means of the following entry and note in the holding company's Profit and Loss Account:

Dividend (gross) (less provisions for losses) from subsidiaries not consolidated:		
For their financial years ending in 1958	£8,696	
For other years	Nil	
	———	£8,696

Note

This company's proportions of the undistributed profits, less losses, of these companies not taken into this company's accounts, after deducting Income Tax were:

For their financial years ending in 1958	£10,000
For prior years since acquisition	20,000
	———
	£30,000

Where shares are held by a subsidiary in a fellow subsidiary, it is recommended by the Council of the Institute that these should be shown separately in the Balance Sheet of the subsidiary.

The recommendations of the Council of the Institute as to the disclosure of interests in subsidiaries in the balance sheet of a holding company are set out on p.291.

§ 4. Consolidated Balance Sheet

(a) General Principles

A consolidated Balance Sheet is really a 'Consolidated Statement of Assets and Liabilities', but the more usual title has much to commend it, as it is, in fact, a consolidation of Balance Sheets.

In order to consolidate Balance Sheets it is desirable for them all to be made up to the same date; otherwise adjustments must be made to enable the exact position at the date of the consolidation to be ascertained. All assets and liabilities should be classified in the same manner, and valuations should be made upon the same basis. If this is not done, adjustments should be made to bring them into line.

It is provided by Section 152 of the Act that where the financial year of a subsidiary does not coincide with that of its holding company, the group accounts must deal with the subsidiary's accounts for its financial year ending with or last before that of the holding company.

Adjustments may be necessary to meet the following circumstances:

(1) To provide for any material trading loss known to have been sustained by the subsidiary between the end of its financial year and the date of the consolidated accounts.

(2) Where large transfers of cash between one company and another have taken place, or a subsidiary has incurred substantial capital expenditure in the interval between the two Balance Sheet dates, so that the liquid position of the group is materially affected.

(3) For the purpose of reconciling the balances on inter-company accounts in respect of cash and other assets in transit at the date of the consolidated accounts. Where, owing to differences in accounting dates, inter-company balances do not cancel out, it is usual to show the net difference in the consolidated balance sheet under an appropriate heading, such as 'Difference on consolidation due to differing accounting dates'.

(b) Wholly-owned Subsidiaries

Where a company acquires the whole of the share capital of another company, the consolidated Balance Sheet will consist, in effect, of the Balance Sheet of the holding company in which, however, the item 'Shares in Subsidiary Company' is replaced by the actual assets and liabilities of the subsidiary, grouped under their appropriate headings with those of the holding company. If the price paid for the shares exceeds the book value of the net assets of the subsidiary, the excess is a premium paid for the right to exercise control over the subsidiary, and must appear in the consolidated Balance Sheet as goodwill, cost of control, or under some other suitable designation.

Since the value of the net assets of a company is represented in its Balance Sheet by the amount of its paid up capital, plus any reserves and other undistributed profits, the amount to be shown in the consolidated Balance Sheet under the heading of goodwill can be ascertained by deducting from the cost of the shares held the nominal amount of the paid-up share capital of the subsidiary plus all reserves and profits existing at the date on which the shares were acquired. The consolidation is then completed by combining the remaining items appearing in the Balance Sheets of both companies.

Illustration (1)

The Balance Sheets of H Ltd., and S Ltd., immediately after the whole of the share capital of S Ltd., had been acquired by H Ltd., were as follows:

	H Ltd.	S Ltd.		H Ltd.	S Ltd.
	£	£		£	£
Share Capital (in £1 shares)	12,000	5,000	Fixed Assets	11,000	7,000
Reserves	5,000	2,000	Current Assets .. .	6,000	4,000
Profit and Loss Account	6,000	1,000	5,000 Shares in S Ltd.	10,000	
	23,000	8,000			
Liabilities ..	4,000	3,000			
	£27,000	£11,000		£27,000	£11,000

It will be seen that the net assets of S Ltd. amount to £8,000, *viz.*, total assets £11,000 less liabilities £3,000 (represented by the Share Capital of £5,000, Reserves £2,000 and Profit and Loss Account £1,000). The excess of the cost of the shares to H. Ltd. over the net assets of S Ltd. is the amount attributable to goodwill.

The following is a convenient formula for ascertaining by double entry procedure the amount to be shown in the consolidated Balance Sheet under the heading of goodwill:

(1) Transfer to the *debit* of Goodwill Account the cost of the shares in the subsidiary company held by the holding company;

(2) Transfer to the *credit* of Goodwill Account from the Share Capital Account of the subsidiary the nominal value of the shares so held;

(3) Transfer to the *credit* of Goodwill Account the proportion attributable to the holding company of any Reserves, Profit and Loss Account credit balance, or other account representing surplus assets of the subsidiary at the date on which the shares were acquired. (Where there are a number of accounts representing reserves or other surpluses, it may be more convenient to transfer the pre-acquisition amounts first to a Capital Reserve Account and from thence to Goodwill Account.)

(4) If, at the date on which the shares were acquired the Profit and Loss Account of the subsidiary was in debit, transfer to the *debit* of Goodwill Account the proportion of such debit balance applicable to the shares in the subsidiary held by the holding company.

The consolidating adjustments may conveniently be made by journal entries, in order that a permanent record thereof may be maintained for future reference, and to facilitate the preparation of the consolidated accounts. The journal entries necessary to apply the foregoing formula to the illustration above would be as follows:

		£	£
Goodwill	*Dr.*	10,000	
To Shares in S Ltd. .. .			10,000
Transfer of cost of 5,000 Shares held in S Ltd.			
Share Capital, S Ltd.	*Dr.*	5,000	
To Goodwill .			5,000
Transfer of nominal value of shares.			
Reserves, S Ltd. . .	*Dr.*	2,000	
Profit and Loss Account, S Ltd. .		1,000	
To Goodwill .. .			3,000
Transfer of pre-acquisition balances.			

The Goodwill Account resulting from the posting of the above journal entries would be:

GOODWILL

To Cost of 5,000 Shares in S Ltd.	10,000	By Share Capital, S Ltd. Nominal value of 5,000 shares	5,000
		„ Pre-acquisition profits	3,000
		„ Balance – Goodwill	2,000
	£10,000		£10,000

CONSOLIDATED BALANCE SHEET

	£	£			
Share Capital		12,000	Fixed Assets:		
Consolidated Reserve		5,000	H Ltd. .	11,000	
Consolidated Profit and Loss Account ..		6,000	S Ltd.	7,000	
					18,000
		23,000	Current Assets		
Liabilities:			H Ltd. ..	6,000	
H Ltd. . ..	4,000		S Ltd. ..	4,000	
S Ltd.	3,000				10,000
		7,000	Goodwill ..		2,000
		£30,000			£30,000

Where, at the date of the acquisition of the controlling interest by the holding company, a subsidiary has a *debit* balance on Profit and Loss Account, its net assets are reduced thereby, and the cost of goodwill is correspondingly increased. For example, if in the above illustration, instead of pre-acquisition profits of £3,000, S Ltd. had a *debit* balance on Profit and Loss Account of £3,000, its net assets would be represented

by Share Capital £5,000 *less* Profit and Loss Account debit balance £3,000 = £2,000, and the sum attributable to goodwill in the consolidated Balance Sheet would be:

Cost of Shares	£10,000
Less Nominal Value	5,000
	5,000
Add Pre-acquisition loss	3,000
	£8,000

or cost of shares £10,000 less net assets £2,000 = £8,000.

It will thus be seen that, for the purpose of the consolidation, the amount of any pre-acquisition surplus, *i.e.*, of any *credit* balance on Reserve or Profit and Loss Account, is transferred to the *credit* of the Goodwill Account, whereas the amount of any pre-acquisition *loss* is transferred to the *debit* of that account. The procedure is, in fact, merely a simple double entry operation – the transfer of a sum from one account to the *same side* of another account.

Where the cost of the shares in the subsidiary is less than the net assets attributable thereto, the balance should appear in the consolidated Balance Sheet under the heading of capital reserve. For example, if in the above illustration the pre-acquisition reserves, etc., of S Ltd. amounted to £7,000, the net assets of S Ltd., would amount to £12,000, and the difference between this sum and the cost of the shares, *viz.*, £2,000, would appear in the consolidated Balance Sheet as a capital reserve.

Where shares have been issued at a premium by one member of the group to another, the credit to Share Premium Account in the Balance Sheet of the issuing company should be set off on consolidation against the premium included in the cost of the shares to the company which subscribed for the shares.

Profits earned by a subsidiary company after it becomes a subsidiary are revenue of the group, and are included in the consolidated Balance Sheet as part of the Revenue Reserves or consolidated Profit and Loss Account balance. When preparing a consolidated Balance Sheet at a date subsequent to that on which the controlling interest was acquired, therefore, it is first necessary to transfer from the Reserve and Profit and Loss Accounts of the subsidiary to Goodwill Account, the amounts of the pre-acquisition surpluses of the subsidiary, leaving any balances of such surpluses to be treated as revenue reserves or profits of the group.

Illustration (2)

The Balance Sheets of the companies referred to in Illustration (1) one year later than the Balance Sheet therein, are as under:

	H Ltd.	S Ltd.		H Ltd.	S Ltd.
	£	£		£	£
Share Capital	12,000	5,000	Fixed Assets	12,000	7,000
Reserves	7,000	3,000	Current Assets	10,000	7,500
Profit and Loss Account	8,000	2,500	5,000 Shares in S Ltd.	10,000	
	27,000	10,500			
Liabilities	5,000	4,000			
	£32,000	£14,500		£32,000	£14,500

Assuming no dividends to have been paid by S Ltd., and no inter-company adjustments to be necessary the increase of £1,000 in the Reserves and £1,500 in the Profit and Loss Account balance of S Ltd., being post-acquisition profits, would be credited to consolidated Reserves and Profit and Loss Account respectively. The consolidated Balance Sheet at this date will then appear as under:

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Share Capital		12,000	Fixed Assets:		
Consolidated Revenue Reserves:			H Ltd. .	12,000	
H Ltd.	7,000		S Ltd. ..	7,000	
S Ltd.	1,000				19,000
		8,000	Current Assets:		
Consolidated Profit and Loss Account:			H Ltd. ..	10,000	
H Ltd.	8,000		S Ltd. .	7,500	
S Ltd	1,500				17,500
		9,500	Goodwill		2,000
		29,500			
Liabilities:					
H Ltd.	5,000				
S Ltd.	4,000				
		9,000			
		£38,500			£38,500

(c) Partly-owned Subsidiaries

Where the holding company does not own the whole of the share capital of the subsidiary, if credit is taken in the consolidated Balance Sheet for the whole of the net assets of the subsidiary, the amount of the minority interest, *i.e.*, the proportion of the net assets applicable to the shares held outside the group, must be shown as a liability. The amount of such liability will comprise the nominal amount of the shares held by the outside shareholders, plus the proportion appropriate thereto of all reserves and undistributed profits of the subsidiary, or less the appropriate proportion of any debit balance on its Profit and Loss Account.

Illustration (3)

Assume the same circumstances as those appearing in Illustrations (1) and (2), but that H Ltd.'s holding in S Ltd., consists of only 4,000 shares, acquired at a cost of £10,000.

As will be seen from the Balance Sheet in Illustration (2), the net assets of S Ltd. amount to £10,500 of which one-fifth = £2,100 is attributable to the 1,000 shares held outside the group. This sum is represented by:

Share Capital	£1,000
One Fifth of Reserve (£3,000)	600
,, ,, ,, Profit and Loss Account Balance (£2,500)	500
	£2,100

Since only four-fifths of the share capital of S Ltd. is held by the holding company, only four-fifths of that company's Reserves and Profit and Loss Account balance will be treated as applicable to the group. The consolidating entries will be:

Goodwill	Dr	£10,000	£
To Shares in S Ltd.			10,000
Transfer of cost of 4,000 Shares held in S Ltd.			
Share Capital, S Ltd.	Dr.	5,000	
To Goodwill . ..			4,000
Minority Interest			1,000
Transfer of nominal value of Shares.			
Reserves, S Ltd.	Dr.	1,600	
Profit and Loss Account, S Ltd...		800	
To Goodwill			2,400
Transfer of proportion of pre-acquisition balances attributable to 4,000 Shares in S Ltd. held by H. Ltd.			
Reserves, S Ltd.	Dr.	600	
Profit and Loss Account, S Ltd...		500	
To Minority Interest			1,100
Transfer of one-fifth of surplus of S Ltd. attributable to 1,000 Shares held by minority shareholders.			

GOODWILL

	£			£
To Cost of 5,000 Shares in S Ltd.	10,000	By Share Capital, S Ltd. Nominal value of 4,000 Shares		4,000
		„ Pre-acquisition surplus:		
		Reserve, 4/5ths of £2,000	£1,600	
		Profit and Loss, 4/5ths of £1,000	800	
				2,400
		„ Balance = Goodwill		3,600
	£10,000			£10,000

MINORITY INTEREST

	£
By Share Capital, S Ltd	1,000
„ Reserves, S Ltd., 1/5th of £3,000	600
„ Profit and Loss, S Ltd., 1/5th of £2,500	500
	£2,100

CONSOLIDATED BALANCE SHEET

		£		£
Share Capital		12,000	Fixed Assets	19,000
Consolidated Revenue Reserve:			Current Assets	17,500
H Ltd.	7,000		Goodwill	3,600
S Ltd. 4/5 × £1,000	800			
		7,800		
Consolidated Profit and Loss Account:				
H Ltd.	8,000			
S Ltd. 4/5 × £1,500	1,200			
		9,200		
		29,000		
Minority Interest		2,100		
Liabilities		9,000		
		£40,100		£40,100

It might be argued that as the holding company paid a premium of £3,600 for a four-fifths interest in the capital of the subsidiary, the true value of the 'goodwill' is £3,600 × $\frac{5}{4}$ = £4,500, and that it should appear in the consolidated Balance Sheet at the latter figure, the balance of £900 being credited to the minority interest. The objection to such a procedure is that the purpose of the consolidated Balance Sheet is to show the state of affairs of the group so far as it affects the members of the holding company and that the price paid by the holding company for a controlling interest may not reflect the value of the shares held by outside shareholders nor the goodwill element included therein. The amount which should appear as goodwill in the Balance Sheet of the group should not exceed the amount actually expended by the group in the acquisition of that asset.

Illustration (4)

SUMMARISED BALANCE SHEETS

	H Ltd.	S Ltd.		H Ltd.	S Ltd.
	£	£		£	£
Share Capital	3,600	2,000	1,600 shares in S Ltd., at cost	1,100	—
Creditors	1,600	600	Sundry Assets	4,800	2,100
Profit and Loss Account	700		Profit and Loss Account		500
	£5,900	£2,600		£5,900	£2,600

H Ltd. acquired the shares in S Ltd. when the latter had a *debit* balance on Profit and Loss Account of £800. On that date, therefore, the net assets of S Ltd. were £1,200 (equal to the net interest of the shareholders, *viz.*, capital £2,000, *less* loss £800). H Ltd. acquired 80% of the shares, on an asset basis (at book value), worth 80% of £1,200 = £960, and therefore paid £1,100 — £960 = £140 for goodwill. Moreover, the debit balance on Profit and Loss Account having been reduced to £500, S Ltd. must have made a profit of £300 since H Ltd. acquired the shares.

Applying the method already explained, the consolidating adjustments would be as follows:

		£	£
Goodwill	Dr	1,100	
To Shares in S Ltd.			1,100
Transfer of cost of 1,600 Shares in S Ltd.			
Shares in S Ltd.		2,000	
To Goodwill ..			1,600
„ Minority Interest			400
Transfer of nominal value of Shares.			
Goodwill		640	
To Profit and Loss, S Ltd.			640
Transfer of proportion of pre-acquisition loss of S Ltd. applicable to H Ltd. – 4/5ths of £800.			
Minority Interest			
To Profit and Loss, S Ltd. ..			100
Transfer of proportion of balance applicable to Minority Interest – 1/5th of £500.			

GOODWILL

	£		£
To Cost of 1,600 Shares in S Ltd.	1,100	By Share Capital, S Ltd. Nominal value of 1,600 Shares	1,600
„ Profit and Loss Account, S Ltd. proportion of pre-acquisition loss of S Ltd. applicable to H Ltd. – 4/5ths of £800	640	„ Balance – Goodwill	140
	£1,740		£1,740

MINORITY INTEREST

			£
To Profit and Loss Account, S Ltd. – 1/5th of debit balance of £500	100	By Share Capital, S Ltd	400
„ Balance to Consolidated Balance Sheet	300		
	£400		£400

PROFIT AND LOSS ACCOUNT, S. LTD.

			£
To Balance b/f.	500	By Transfer to Goodwill	640
„ Consolidated Profit and Loss Account, being post-acquisition profit applicable to H Ltd. – 4/5ths of £300 ..	240	„ „ „ Minority Interest	100
	£740		£740

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Share Capital		3,600	Goodwill .		140
Consolidated Profit and Loss Account:			Sundry Assets H Ltd	4,800	
H Ltd.	700		S Ltd	2,100	
S Ltd.	240				6,900
		940			
Minority Interest		300			
Creditors H Ltd.	1,600				
S Ltd.	600				
		2,200			
		£7,040			£7,040

It should, however, be noted that the £240 credited to the consolidated Profit and Loss Account in respect of post-acquisition profits of S Ltd. is not available for distribution, since in fact, S Ltd. still has a debit balance on its Profit and Loss Account.

Illustration (5)

The following are the Balance Sheets of a holding company and its subsidiary company:

	H Ltd.	S Ltd.		H Ltd.	S Ltd
	£	£		£	£
Share Capital	1,600	900	720 Shares in S Ltd. at cost	800	—
Creditors	300	550	Sundry Assets	1,500	1,250
Profit and Loss Account	400	—	Profit and Loss Account	—	200
	£2,300	£1,450		£2,300	£1,450

When H Ltd. acquired the shares in S Ltd., the latter had a *credit* balance on Profit and Loss Account of £150. No dividends have been declared by S Ltd. Prepare a consolidated Balance Sheet.

The consolidating entries will be:

		£	£
Goodwill	*Dr.*	800	
To Share Capital S Ltd.			800
Transfer of cost of 720 Shares in S Ltd.			
Share Capital S Ltd.	*Dr.*	900	
To Goodwill			720
,, Minority Interest			180
Transfer of nominal value of shares.			
Profit and Loss, S Ltd...	*Dr.*	120	
To Goodwill			120
Transfer of 4/5ths of £150 being pre-acquisition surplus of S Ltd			
Minority Interest	*Dr.*	40	
To Profit and Loss			40
Transfer of 1/5th of debit balance on Profit and Loss Account applicable to minority shareholders.			

GOODWILL

	£		£
To Cost of 720 Shares in S Ltd.	800	By Share Capital, S Ltd. Nominal value of 720 Shares	720
,, Transfer to Capital Reserve.	40	,, Profit and Loss, S Ltd., Pre-acquisition profit..	120
	£840		£840

CAPITAL RESERVE

			£
		By Transfer from Goodwill	40

PROFIT AND LOSS ACCOUNT

	£		£
To Balance b/f.	200	By Minority Interest – 1/5th of £200	40
,, Goodwill Transfer of pre-acquisition *credit* balance applicable to H Ltd. – 4/5ths of £150	120	,, Balance to consolidated Balance Sheet	280
	£320		£320

MINORITY INTEREST

			£
To Profit and Loss, S Ltd. Share of *debit* balance – 1/5th of £200	40	By Share Capital, S Ltd.	180
,, Balance to consolidated Balance Sheet	140		
	£180		£180

The net assets of S Ltd. at the date of acquisition of the 720 shares therein by H Ltd. were represented by:

Share Capital	£900
Profit and Loss Account	150
	£1,050

of which four-fifths = £840 is attributable to H Ltd.'s holding. Since H Ltd. only paid £800 for the shares, it paid, in fact, nothing for goodwill, but acquired, in effect, a capital reserve of £40, which is shown as such in the consolidated Balance Sheet. The 'goodwill' entries in the above solution are not therefore strictly necessary, but have been shown for the sake of consistency of treatment, the balance of goodwill being transferred to capital reserve.

As S Ltd. had a *credit* balance of £150 on Profit and Loss Account at the date of acquisition of the shares therein by H Ltd., but now has a *debit* balance of £200, it has made a post-acquisition loss of £350, of which four-fifths = £280 is applicable to H Ltd.'s holding. This amount is *debited* to Consolidated Profit and Loss Account.

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Share Capital		1,600	Sundry Assets – H Ltd. ..	1,500	
Consolidated Profit and Loss Account –			S Ltd	1,250	
H Ltd.	400				2,750
Less Proportion of post-acquisition loss of S Ltd. ..	280				
		120			
Capital Reserve		40			
Minority Interest . ..		140			
Creditors – H Ltd.	300				
S Ltd. . ..	550				
		850			
		£2,750			£2,750

(d) Losses incurred by Subsidiary

Where a subsidiary has incurred losses these should be charged to the holding company and the minority holders of ordinary shares (if any) in proportion to their holdings, as has been done in illustrations (4) and (5) above. If, however, a subsidiary continues to incur losses after all its previously earned reserves and profits have been exhausted, the minority shareholders should not be charged with any part of such losses in excess of the nominal value of the shares held by them, as their liability is limited to such nominal value. In such a case, if it is not proposed to wind up the subsidiary, the holding company should make provision in its own accounts for such excess losses. If, however, the holding company intends to abandon the subsidiary and allow it to be wound up, the amount of the investment in the subsidiary would be written off in the holding company's books without providing for such excess losses. In these circumstances no good purpose would be served in including the subsidiary in group accounts.

(e) Dividends paid by a Subsidiary out of pre-acquisition profits

Since profits of a subsidiary earned prior to and remaining undistributed at the date on which the parent company acquires its shares therein are represented by assets which are, in effect, paid for by the holding company as part of the purchase price of

the shares, any dividends paid by a subsidiary out of such pre-acquisition profits must be treated as receipts of a capital nature not available for distribution by the holding company. Such dividends represent in effect, a realisation of part of the price paid for the shares, and must be credited to the Shares in Subsidiary Account, thus reducing the cost of the shares to the holding company, and, in consequence, the amount applicable to goodwill.

Illustration (6)

The Balance Sheets of H Ltd. and S Ltd. at the date on which H Ltd. acquired 75% of the ordinary share capital of S Ltd., were as follows:

BALANCE SHEETS

	H Ltd.	S Ltd.		H Ltd.	S Ltd.
	£	£		£	£
Share Capital ..	200,000	40,000	30,000 Shares in S Ltd.	60,000	
Reserves	40,000	10,000	Sundry Assets, *less* liabilities	205,000	64,000
Profit and Loss Account	25,000	14,000			
	£265,000	£64,000		£265,000	£64,000

It will be apparent that since the net assets of S Ltd. amount to £64,000, and H Ltd. has become the owner of three-fourths of the share capital of S Ltd., the net assets of S Ltd., attributable to H Ltd.'s holding amount to £48,000, and the price paid by H Ltd. for goodwill is £60,000 − £48,000 = £12,000.

If, immediately after the purchase of the shares by H Ltd., S Ltd., paid a 'free of tax' dividend of 20%, the effect would be to reduce the net assets of S Ltd. by £8,000 to £56,000, and the proportion thereof applicable to H Ltd.'s holding to ¾ × £56,000 = £42,000. If the cost of the shares remained in H Ltd.'s books at £60,000, the amount appearing as goodwill in the consolidated Balance Sheet would be increased to £18,000, and the £6,000 dividend received by H Ltd. would be incorrectly credited to its Profit and Loss Account, causing the divisible profits of that company to appear to be £6,000 more than the amount which is legally distributable. The dividend should, therefore, be credited to the Shares in Subsidiary Account, and in the consolidated Balance Sheet, goodwill and minority interest would appear as under:

GOODWILL

				£
To Cost of 30,000 Shares in S Ltd.	60,000	By Share Capital, S Ltd., Nominal value of 30,000 Shares		30,000
Less Dividend received out of pre-acquisition profit	6,000	,, Pre-acquisition reserves and profits ..	24,000	
		Less Dividend paid thereout ..	8,000	
	54,000			
		Applicable to H. Ltd. ¾ths of .	£16,000	12,000
		,, Balance to Consolidated Balance Sheet		12,000
	£54,000			£54,000

MINORITY INTEREST

	£		£
To Balance to Consolidated Balance Sheet .	14,000	By Share Capital, S Ltd.	10,000
		,, Reserves and Profits, *less* dividend paid thereout ¼ × £16,000	4,000
	£14,000		£14,000

(f) Future Income Tax Reserve

In view of the recommendation of the Council of the Institute of Chartered Accountants (see page 289) that amounts set aside for future income tax should not be grouped with reserves, it is considered that such an item appearing in the balance sheet of a subsidiary at the date of the acquisition of shares therein by the holding company should not be treated for the purpose of the consolidated balance sheet as part of the pre-acquisition reserves of the subsidiary, neither should any part of an amount so set aside by a subsidiary be included in the liability to minority interests. The best modern practice appears to be to treat such an item neither as a reserve nor as a provision, but to place it in a separate category as an 'amount set aside for future income tax'. For the purpose of the group accounts, the aggregate of the amounts set aside for future income tax by all the members of the group should be shown as a separate item in the consolidated balance sheet.

(g) Bonus Shares received by Holding Company from Subsidiary

Where, as sometimes happens, a subsidiary company capitalizes profits by the issue of bonus shares, the treatment in the group accounts of the bonus shares received by the holding company will depend upon whether the bonus is paid out of pre-acquisition or post-acquisition profits. It will be appreciated that the effect of capitalizing profits in this way is to freeze them from distribution as dividend. If, therefore, the bonus is declared out of post-acquisition profits which are standing to the credit of consolidated Profit and Loss Account or Reserve a sum equal to the amount capitalized should be transferred therefrom to Capital Reserve Account. If this is not done, the aggregate of the revenue reserves appearing in the consolidated Balance Sheet will exceed the maximum sum which could be distributed as dividend to the members of the holding company were all the subsidiaries to pay to the holding company as dividends the whole of their profits available for distribution. If, however, the bonus is declared out of pre-acquisition profits, no adjustment is necessary, since these profits have already been treated as capital in the consolidated accounts in computing goodwill, and no longer appear therein as revenue reserves.

(h) Preference Shares in Subsidiaries

It has been assumed in the preceding examples that the shares held by the outside members are ordinary shares, so that the minority interest in the net assets is represented by the nominal value of the capital held by them plus the proportion of all reserves and undistributed profits or less the proportion of losses attributable to such holding. Where the shares held by outside members are preference shares, which do not participate in the surplus profits or assets, the minority interest will normally consist of the nominal value of the preference shares held by the outside shareholders plus only the amount of the fixed dividend accrued on the shares to the date of the consolidated Balance Sheet.

Where preference shareholders are entitled to share in a surplus on a winding-up it might be contended that they should be credited also with a share of the surplus assets proportionate to their capital. Since, however, the consolidated Balance Sheet is intended to show the position of the group as a going concern, it is considered that

such a contention cannot be upheld. If it were proposed to wind up the subsidiary, its accounts would probably not be consolidated with those of the holding company. Until liquidation supervenes, the ordinary shareholders (subject to any special rights given to other classes) are entitled to all undivided profits, and the preference shareholders only to their fixed dividends. Any rights of the preference shareholders to participate in a possible surplus can, if thought fit, be mentioned in a footnote. Redeemable preference shares which are redeemable at a premium are in a different category, and prudence would seem to dictate that the premium should be provided for by annual instalments over the period between the date of the Balance Sheet and the redemption date.

If the holding company itself holds preference shares in the subsidiary, the nominal value will be deducted from the cost thereof to the holding company, in the same way as in the case of ordinary shares, any premium or discount on the purchase being deducted from, or added to, goodwill, as the case may be. The fixed dividend thereon accrued to the date of acquisition will be transferred to goodwill as being the proportion of the pre-acquisition profits of the subsidiary applicable to the preference shares.

Participating preference shares in a subsidiary present a special problem, the solution to which must depend upon the rights of the holders of such shares as laid down in the company's articles. For example, the shares may be cumulative in respect of the fixed dividend, but non-cumulative as regards the further participation up to a specified maximum. Where such shares are held by outside shareholders it is usually desirable to allocate the profits of the subsidiary between them and the holding company on the assumption that the whole of the profits are to be distributed. The minority shareholders of the participating preference shares would thus be credited with the maximum sum they could expect to receive. If this is not done a note should be appended to the accounts indicating the rights attaching to such shares and the amount of their maximum possible participation.

Where the profits of a subsidiary have been insufficient to pay, in whole or in part, the cumulative dividend on preference shares, there would be no obligation to provide for arrears of dividend out of the consolidated profits except to the extent that the existing reserves of the subsidiary in question are sufficient to meet them, but a note should be made on the consolidated Balance Sheet of the amount of such arrears not provided for.

Where the subsidiary has a debit balance on Profit and Loss Account, this should normally be charged against the ordinary shareholders only, as the holders of the cumulative preference shares are entitled to have arrears of dividend paid out of future profits, and thus the debit balance on Profit and Loss Account would be borne by the ordinary shareholders. In the exceptional case where the winding-up of the subsidiary is imminent, however, if the preference shares carry no right to priority of repayment of capital the debit balance should quite properly be apportioned between the holders of the ordinary and the preference capital. In such a case, however, it is improbable that the subsidiary would be included in the group accounts.

(i) Inter-Company Balances

In the preparation of the consolidated Balance Sheet, it is necessary to eliminate all inter-company balances which represent neither assets nor liabilities of the group as a whole. Such balances may arise from various transactions, the more important being those relating to dividends, inter-company bills of exchange, and inter-company trading.

Where a dividend has been declared by the subsidiary company, but has not been paid, the whole dividend will appear as a liability in the Balance Sheet of the subsidiary company, whilst the amount due to the holding company will be shown in the latter's Balance Sheet as an asset. In the consolidated Balance Sheet this amount will be set off against the liability for the dividend appearing in the Balance Sheet of the subsidiary company, and the balance, being the dividend due to the outside members, will be included in the amount of the minority interest.

The necessary adjustment is considered in greater detail in § 5 of this chapter dealing with the consolidated Profit and Loss Account.

Bills of exchange drawn by the one company and accepted by another member of the group are shown in the separate Balance Sheets as bills receivable and bills payable respectively. In the consolidated Balance Sheet these items will cancel each other out, since they merely represent inter-company indebtedness, and are not assets or liabilities of the group. If, however, a member of the group has discounted any bills drawn by it on, and accepted by, other members of the group, the discounted bills will not appear as assets in the first company's Balance Sheet, but a contingent liability will be noted thereon in respect of them. In the consolidated Balance Sheet, however, the discounted bills will appear as an actual, not a contingent liability, since they are held by persons outside the group, to whom the amounts of the bills will have to be paid on maturity. Only the inter-company bills actually held within the group at the date of the consolidated Balance Sheet will cancel out.

Illustration (8)

The following are extracts from the Balance Sheets as at 31st December of a holding company and its subsidiary company. The holding company has a 90 per cent. interest in the subsidiary company. Show how the items would appear in the consolidated Balance Sheet.

HOLDING COMPANY

			£
Note. There is a contingent liability on Bills Discounted – £1,500		Bills Receivable (accepted by Subsidiary Company)	2,000

SUBSIDIARY COMPANY

	£
Bills Payable (drawn by Holding Company)	3,500

CONSOLIDATED BALANCE SHEET

	£	£
Bills Payable..	3,500	
Less held by Holding Company ..	2,000	
		1,500

Any inter-company indebtedness, in the form of trade debts, loans or Current Account balances, which appears as a liability in the Balance Sheet of one member of the group and as an asset in the Balance Sheet of another, will cancel out in the consolidated Balance Sheet.

Any difference between the balance on an inter-company Current Account in one company's books and that of the corresponding Current Account in the books of the other company will usually be occasioned by cash or goods in transit, or some other transaction which has been recorded in one set of books but not in the other. The amount of such difference must be transferred out of the Current Account affected to the appropriate value in transit account and shown in the consolidated Balance Sheet as an asset. The Current Accounts in the respective books will then cancel out.

(j) Unrealised Inter-Company Profits

Where goods which have been sold by one company in the group to another at a profit, have not been resold by the latter company at the date of its Balance Sheet, and are included in its stock at the price at which they were invoiced by the selling company, the profit on the transaction (which, from the point of view of the group is unrealised) must be deducted from the stock and from the consolidated profit for the purpose of the consolidated accounts. Where, however, any part of the capital of a subsidiary is held by members outside the group, only the proportion of the inter-company profit on the transaction which is attributable to the members of the group must be regarded as unrealised, and deleted. From the point of view of the outside shareholders, the profit is a realised one arising from a purchase or sale of goods by the company of which they are members from or to another company, and no adjustment is necessary in respect of their interest in such profit. Where, for example, only four-fifths of the capital of the subsidiary is held by the holding company, only four-fifths of the inter-company profit on the unsold stock will be deducted from the figures of stock and of profit in the consolidated accounts. This adjustment is illustrated in § 5 of this chapter in describing the preparation of a consolidated Profit and Loss Account.

A similar position arises where one company in the group executes work of a capital nature for another company in the group, *e.g.*, where a subsidiary manufactures plant and machinery that is acquired by the holding company or another subsidiary as a fixed asset. Here again any unrealised profit must be eliminated from the consolidated accounts by being deducted from the book value of the plant and from the profit.

Where there is a chain of companies the minority interest in each of the companies affected by the transaction must be taken into account in making the necessary adjustment. For example, if X holds 90 per cent. of the capital of Y, and Y holds 80 per cent. of the capital of Z, in respect of any profit included in the invoiced price of assets sold by X or Y to Z, or by Z to X or Y, 90 per cent. of 80 per cent. = 72 per cent. is applicable to the group, and must be eliminated from the consolidated profit and consolidated assets. The minority interest consists of:

Outside shareholders of Z	20%
Outside shareholders of Y – 10 per cent. of 80 per cent. ..	8%
	28%

The effect of the above adjustments is to include the stock or other relevant assets in the consolidated Balance Sheet at more than their actual cost to the group, the excess being included on the opposite side of the Balance Sheet as part of the liability to outside shareholders.

Another line of argument is that the minority interest should not be increased by any proportion of the profit on such inter-company transactions until it has been fully realised by the group on their behalf. If this view is taken provision should be made for the full amount of the unrealised profit, irrespective of the interest of minority shareholders.

(k) Revaluation of Assets of Subsidiary Company

Where any of the assets of a subsidiary company have been revalued for the purpose of arriving at the price to be paid for the shares by the holding company, although no adjustment has been made in the books of the subsidiary company, it is preferable to include in the consolidated Balance Sheet the difference in value as a specific addition to, or deduction from, the assets affected, increasing or decreasing the capital reserve and the liability to minority interests accordingly.

Any such increase or decrease in value will necessitate an adjustment of the charge for depreciation in the consolidated Profit and Loss Account and such adjustment must be made *before* arriving at the proportion of the profits attributable to outside shareholders.

Illustration (9)

If plant and machinery standing in the books of the subsidiary company at £10,000 had been revalued for the purpose of fixing the price of the shares purchased, at £15,000, and depreciation had been written off in the books of the subsidiary company at the rate of 10 per cent., on the book value of £10,000 only, the subsidiary company's plant and machinery would be shown in the consolidated Balance Sheet one year later as:

	£	£	£
Plant at cost, per books		10,000	
Less Depreciation written off		1,000	
		9,000	
Add Excess of valuation over book value	5.000		
Less Depreciation on such excess ..	500		
		4,500	
			13,500

whilst the charge for depreciation in the Consolidated Profit and Loss Account will be increased by £500.

For the purpose of the consolidated accounts the outside shareholders will have been credited with their share of the £5,000 appreciation in value as part of the capital reserve, and will automatically be charged with their proportion of the increased depreciation since their share of profit will be a proportion of the reduced amount.

Illustration (10)

The following are the Balance Sheets of H Ltd. and its subsidiary S Ltd.

Prepare a consolidated Balance Sheet having regard to the following:

(*a*) On the date when H Ltd. acquired the shares in S Ltd. the latter had a reserve of £500 and a credit balance on Profit and Loss Account of £100. The shares in H Ltd., allotted in exchange for those of S Ltd., were issued at a premium of 10s. per £1 share.

(*b*) In arriving at the value of the S Ltd. shares, plant and machinery, which then stood in the books at £4,500, was revalued at £5,400; and furniture, etc., standing in the books at £600, was revalued at £360. The new values were not incorporated in the books. No changes in these assets have been made since that date.

(*c*) S Ltd. has purchased goods from H Ltd., of which goods invoiced at £1,400 are still in stock. H Ltd. adds 25% to cost in arriving at the invoice price to S Ltd.

BALANCE SHEETS

	H Ltd.	S Ltd.		H Ltd	S Ltd
	£	£		£	£
Share Capital	22,000	8,000	Goodwill	3,500	2,500
Premium on 5,200 shares	2,600	—	Plant, etc.	7,000	3,900
Reserve .. .	-	2,000	Furniture, etc ..	1,200	500
Profit and Loss Account	2,800	600	Stock . ..	4,000	2,700
Sundry Creditors ..	1,900	2,300	Debtors	5,000	3,100
Current Account, H Ltd.		700	Current Account, S Ltd.	700	
			Bank Balance ..	100	900
			Shares in S Ltd., 7,200 at cost	7,800	
	£29,300	£13,600		£29,300	£13,600

The following consolidating adjustments must be made:

CONSOLIDATING JOURNAL ENTRIES

Goodwill .	Dr	7,800	
To Shares in S Ltd. . .			7,800
Transfer of cost of shares in S Ltd			
Share Capital, S Ltd. . ..	Dr.	8,000	
To Goodwill – 9/10ths .			7,200
,, Minority Interest 1/10th			800
Transfer of nominal value of shares in S Ltd.			
S Ltd. Revenue Reserves	Dr.		
To Minority Interest .			
Reserve 1/10th of £2,000		200	
Profit and Loss Account – 1/10th of £600		60	
Transfer of share of revenue reserves attributable to outside shareholders			
S Ltd., Revenue Reserves	Dr.		
To Goodwill .			
Reserve 9/10ths of £500 ..		450	
Profit and Loss Account - 9/10ths of £100		90	
Transfer of pre-acquisition surplus of S Ltd. applicable to H Ltd.			
Plant, S Ltd. .	Dr.	900	
To Furniture, S Ltd			240
,, Revaluation Account . .			660
Giving effect to revaluation of assets of S Ltd.			
Revaluation Account ..	Dr.	660	
To Minority Interest (1/10th)			66
,, Goodwill (9/10ths) .			594
Transfer of net increase on revaluation.			
Consolidated Profit and Loss Account	Dr.	72	
Minority Interest		8	
To Provision for Depreciation			80
Adjustment of charge for depreciation consequent on revaluation of assets:			
Plant increase	£120		
Furniture – decrease	40		
Net increase	£80		
Chargeable 9 10ths to Consolidated Profit and Loss Account and 1/10th to Minority interests.			
H Ltd., Profit and Loss Account	Dr.	2,800	
S Ltd., Revenue Reserves (pre-acquisition profits): Reserve	£1,500		
Profit and Loss Account	500		
9/10ths of	£2,000	1,800	
To Consolidated Revenue Reserves			4,600
Transfer of balances.			

CONSOLIDATING JOURNAL ENTRIES (*continued*)

		£	£
Consolidated Profit and Loss Account . . .	*Dr.*	252	
To Stock, S Ltd.			252
Provision for unrealised profit on inter-company trading 9/10ths × 25/125ths × £1,400.			
Current Account, H Ltd. .			
To Current Account, S Ltd.			
Cancellation of inter-company balance.			

CONSOLIDATING LEDGER ACCOUNTS

GOODWILL

	£		£
To Goodwill H Ltd. . . .	3,500	By Share Capital, S Ltd.	7,200
,, S Ltd.	2,500	,, Pre-acquisition profits .	540
		,, Net increase on revaluation of assets	594
	6,000	,, Balance to Consolidated Balance Sheet	5,466
,, Shares in S Ltd.	7,800		
	£13,800		£13,800

S LTD. REVENUE RESERVES

	£		£
To Minority Interest (1/10th)	260	By Reserves . .	2,000
,, Goodwill – pre-acquisition profits (9/10ths of £600)	540	,, Profit and Loss Account	600
,, Consolidated Revenue Reserves – post-acquisition profits (9/10th of £2,000)	1,800		
	£2,600		£2,600

MINORITY INTEREST

	£		
To Share of increase in charge for depreciation on S Ltd.'s plant and furniture (1/10th of £80) .	8	By S Ltd. Share Capital (1/10th of £8,000)	800
,, Balance per consolidated Balance Sheet . .	1,118	,, S Ltd. Revenue Reserves	260
		,, Share of increase on revaluation of S Ltd.'s plant and furniture (1/10th of £660)	
	£1,126		

CONSOLIDATED REVENUE RESERVES

	£		£
To Share applicable to H Ltd. of increase in charge for depreciation on S Ltd.'s plant and furniture (9/10ths of £80)	72	By H Ltd. – Profit and Loss Account	2,800
,, Provision for unrealised profit on Stock . .	252	,, S Ltd. Post-acquisition profits	1,800
,, Balance per Consolidated Balance Sheet . .	4,276		
	£4,600		£4,600

CONSOLIDATED BALANCE SHEET

		£					
Share Capital		22,000	Goodwill				5,466
Share Premium Account		2,600	Plant, etc., H Ltd.			7,000	
Revenue Reserves . .		4,276	S Ltd. . . .		3,900		
			Add Increase on revaluation	£900			
		28,876	*Less* Depreciation thereon	120			
Minority Interest in subsidiary		1,118			780		
Sundry Creditors H Ltd.	1,900					4,680	
S Ltd.	2,300						11,680
		4,200	Furniture, etc. H Ltd. . . .			1,200	
			S Ltd.		500		
			Deduct Reduction in value	£240			
			Less Depreciation thereon	40			
					200		
						300	
							1,500
			Stock H Ltd. . . .			4 000	
			S Ltd . . .		2,700		
			Less Provision for unrealised profit . . .		252		
						2,448	
							6,448
			Debtors H Ltd.			5,000	
			S Ltd. . .			3,100	
							8,100
			Bank Balance H Ltd. . . .			100	
			S Ltd			900	
							1,000
		£34,194					£34,194

Notes.

(1) In the above illustration the Revenue Reserves have been grouped under one heading in accordance with the recommendations of the Council of the Institute of Chartered Accountants (see page 288).

(2) Some authorities prefer to show the consolidation of the goodwill figures actually appearing in the holding company's and subsidiary company's Balance Sheets separately from the sum attributable to cost of control. If this were done in the present example, Goodwill would appear in the consolidated Balance Sheet at £6,000, and £534, being the excess of the book value of the net assets of S Ltd. applicable to H Ltd.'s holding over the cost of such holding, would appear on the opposite side of the Balance Sheet as a Capital Reserve.)

(I) Subsidiaries holding Shares in other Subsidiaries

The following are illustrations involving a holding company and two subsidiaries one of which holds shares in the other:

Illustration (11)

The following is an abstract of the Balance Sheets of Holding Ltd. and its subsidiaries A Ltd. and B Ltd. as on 31st December. Prepare a consolidated Balance Sheet.

	Holding Ltd.		A Ltd.		B Ltd	
	£	£	£	£	£	£
Share Capital Authorised and Issued:						
Ordinary Shares of £1 each, fully paid		100,000		40,000		30,0
Share Premium Account:						
(Premium on issue of 20,000 Shares issued in payment for 30,000 Shares in A Ltd.)		10,000				
Profit and Loss Account:						
Balance brought forward	3,000				6,000	
Add Profit for year	20,000				3,000	
		23,000				9,0
Sundry Creditors		19 000		20,000		3,0
Bills Payable (all issued to Holding Ltd.)				18,000		
		£152,000		£78,000		£42,000

Note. Holding Ltd. had a contingent liability in respect of Bills discounted, £10,000. Sundry Creditors of A Ltd., £20,000, includes £15,000 owed to Holding Ltd.

	Holding Ltd.		A Ltd.		B Ltd.	
	£	£	£	£	£	£
Goodwill at cost				6,000		
Land, Buildings, Plant and Machinery, at cost		25,000		30,000		20,000
Investments, at cost:						
30,000 Ordinary Shares in A Ltd.	30,000					
20,000 ,, ,, ,, B Ltd.	40,000					
		70,000				
10,000 ,, ,, ,, B Ltd.				20,000		
Stocks, as valued by Companies' officials		10,000		3,000		8,000
Sundry Debtors	10,000			2,000		7,000
Advance to A Ltd.	15,000					
		25,000				
Bills Receivable (accepted by A Ltd.)		8,000				
Balances at Bankers		14,000		6,000		7,000
Profit and Loss Account:						
Balance brought forward			5,000			
Add Loss for year			6,000			
				11,000		
		£152,000		£78,000		£42,000

On 1st January of the previous year, the date when Holding Ltd. purchased the 30,000 Shares in A Ltd., the debit balance on the latter company's Profit and Loss Account was £1,000. Holding Ltd. and A Ltd. both purchased their shares in B Ltd. on 1st January in the current year.

CONSOLIDATING JOURNAL ENTRIES

		£	£
Goodwill ..	Dr.	90,000	
To Shares in A Ltd. ..			30,000
,, Shares in B Ltd. – held by Holding Ltd			40,000
,, Shares in B Ltd. – held by A Ltd.			20,000
Transfer of cost of shares.			
Share Capital, A Ltd. ..	Dr.	40,000	
To Goodwill — Nominal Value of Shares held by Holding Ltd.			30,000
,, Minority Interest — Nominal Value of Shares held by Minority Shareholders			10,000
Share Capital, B Ltd. ..	Dr.	30,000	
To Goodwill – Nominal Value of Shares held by Holding Ltd.			20,000
,, Goodwill – Nominal Value of Shares held by A Ltd.			10,000
Transfer of nominal value of shares.			
Goodwill ..	Dr.	750	
To Profit and Loss Account, A Ltd.			
Transfer of pre-acquisition loss of A Ltd applicable to Holding Ltd. – ¾ × £1,000.			
Profit and Loss Account, B Ltd.	Dr.	6,000	
To Goodwill – re Holding Ltd.'s holding – ⅔ × £6,000			4,000
,, Goodwill – re A Ltd.'s holding – ⅓ × £6,000			2,000
Transfer of pre-acquisition profit of B Ltd.			
Sundry Creditors, A Ltd. ..	Dr.	15,000	
To Advance to A Ltd.			15,000
Elimination of inter-company balance.			
Bills Payable, A Ltd. ..	Dr.	8,000	
To Bills Receivable, Holding Ltd.			8,000
Elimination of inter-company bills.			
Profit and Loss Account, B Ltd.	Dr.	3,000	
To Profit and Loss Account, A Ltd. – ⅓ × £3,000			1,000
,, Profit and Loss Account, Holding Ltd. – ⅔ × £3,000			2,000
Transfer of B Ltd.'s post-acquisition profit.			
Profit and Loss Account, Holding Ltd.	Dr.	6,750	
Minority Interest ¼ (£11,000 – £1,000) ..		2,500	
To Profit and Loss Account, A Ltd.			9,250
Transfer of balances on A Ltd.'s Profit and Loss Account.			

Note: The sum debited to Minority Interests in respect of the debit balance on A's profit and loss account is:

	£	
Debit balance per balance sheet ..	11,000	
Less Proportion of B's post-acquisition profit applicable to A Ltd 1/3rd of £3,000	1,000	
One-fourth of	£10,000	= £2,500

GOODWILL

	£		£
To Shares in A Ltd. ..	30,000	By Share Capital A Ltd. Nominal Value	30,000
,, Profit and Loss Account: A Ltd Pre-acquisition loss ..	750	,, Balance – Goodwill	750
	£30,750		£30,750
To Shares in B Ltd. held by Holding Ltd.	40,000	By Share Capital B Ltd. Nominal Value	20,000
		,, Profit and Loss Account – B Ltd. Pre-acquisition profit	4,000
		,, Balance — Goodwill	16,000
	£40,000		£40,000
To Shares in B Ltd. held by A Ltd.	20,000	By Share Capital, B Ltd. Nominal Value	10,000
		,, Profit and Loss Account, B Ltd Pre-acquisition profit ..	2,000
		,, Balance = Goodwill	8,000
	£20,000		£20,000

The goodwill appearing in the consolidated Balance Sheet will be:

	£
Balance per A Ltd.'s Balance Sheet ..	6,000
Holding Company's Goodwill in A Ltd. (as above)	750
,, ,, ,, ,, B Ltd. ,, ,,	16,000
A Ltd.'s ,, ,, ,, B Ltd. ,, ,,	8,000
	£30,750

MINORITY INTEREST

	£		£
To Profit and Loss Account A Ltd. Share of Loss ..	2 500	By Share Capital, A Ltd.	10,000
,, Balance to Consolidated Balance Sheet ..	7,500		
	£10,000		£10 000

CONSOLIDATED PROFIT AND LOSS ACCOUNT

To A Ltd.'s Profit and Loss Account, Share of post-acquisition loss applicable to Holding Ltd. ..	6,750	By Holding Ltd.'s Profit and Loss Account: Balance b/f.	23,000
,, Balance to Consolidated Balance Sheet ..	18,250	, B Ltd.'s Profit and Loss Account – Share of post-acquisition profit applicable to Holding Ltd.	
	£25 000		£25,000

A LTD., PROFIT AND LOSS ACCOUNT

	£		£
To Balance b/f	11,000	By Goodwill - Pre-acquisition loss applicable to Holding Ltd.	750
		,, B Ltd. Profit and Loss Account – Share of post-acquisition profit applicable to A Ltd.	1,000
		,, Minority Interest ½ (£11,000 — £1,000) ..	2,500
		,, Balance to Consolidated Profit and Loss Account	6,750
	£11,000		£11,000

B LTD., PROFIT AND LOSS ACCOUNT

			£
To Goodwill – Pre-acquisition profits applicable to:		By Balance b/f	9,000
A Ltd.	4,000		
B Ltd.	2,000		
,, A Ltd.: Profit and Loss Account – Share of post-acquisition profit applicable to A Ltd. ..	1,000		
,, Consolidated Profit and Loss Account – Share of post-acquisition profit applicable to Holding Ltd.	2,000		
	£9,000		£9,000

CONSOLIDATED BALANCE SHEET OF HOLDING LTD. AND ITS SUBSIDIARY COMPANIES AS AT 31ST DECEMBER

			£
SHARE CAPITAL Authorised and Issued			100,000
CAPITAL RESERVE:			
Share Premium Account			10,000
CONSOLIDATED PROFIT AND LOSS ACCOUNT			18,250
			128,250
MINORITY INTEREST			7,500
SUNDRY CREDITORS:			
H Ltd.		19,000	
A Ltd.	£20,000		
Less due to H Ltd.	15,000		
		5,000	
B Ltd. .. .		3,000	
			27,000
BILLS PAYABLE:			
A Ltd.		18,000	
Less held by H Ltd.		8,000	
			10,000
			£172,750

		£	£
FIXED ASSETS			
Goodwill			30,750
Land, Buildings, Plant and Machinery, at cost:			
H Ltd.		25,000	
A Ltd.		30,000	
B Ltd.		20,000	
			75,000
			105,750
CURRENT ASSETS:			
Stocks—			
H Ltd. ..	10,000		
A Ltd. ..	3,000		
B Ltd. ..	8,000		
		21,000	
Sundry Debtors—			
H Ltd. ..	10,000		
A Ltd. .	2,000		
B Ltd.	7,000		
		19,000	
Balances at Bankers			
H Ltd. ..	14,000		
A Ltd. ..	6,000		
B Ltd. ..	7,000		
		27,000	
			67,000
			£172,750

It will be observed in the above illustration that in computing the goodwill element of £8,000 in A Ltd.'s holding in B Ltd. no part of the pre-acquisition profits of B Ltd. applicable to A Ltd. is credited to the outside shareholders of A Ltd. The reason for this is that such pre-acquisition profits are represented by part of the assets of B Ltd. which A Ltd. has, in effect, purchased and paid for out of its capital funds, and are not revenue available for distribution by A Ltd. among its shareholders. The excess of the price paid by A Ltd. for these shares over the net assets by which they are represented at the date of their acquisition is the sum paid by A Ltd. for goodwill, which would appear as such in the consolidated Balance Sheet of A Ltd. and B Ltd. were the accounts of these two companies consolidated separately. It is one of the assets of A Ltd. whoever its shareholders may be.

Some accountants take the view that only the proportion of this goodwill which is attributable to the members of the holding company should appear in the consolidated Balance Sheet of the group and accordingly that the proportion of the goodwill applicable to the outside members should be eliminated. If this were done in the above illustration, one-fourth of the £8,000 paid by A Ltd. for goodwill in respect of its holding in B Ltd. would be written off against the outside shareholders, thereby reducing the goodwill figure in the consolidated Balance Sheet to £28,750 and the minority interest to £5,500. There would seem to be no logical justification for this procedure; the goodwill is in no different category from the other assets of A Ltd. and if part of the goodwill is written off against outside shareholders it would be logical to write off part of the other assets also, and thereby eliminate the minority interest from the consolidated accounts altogether, including therein only the proportion of each asset of the subsidiary which is, in effect, owned by the holding company.

If, however, the price paid by A Ltd. for the shares in B Ltd. were *less* than the value of the net assets attributable to the holding, so that instead of 'goodwill' there was a 'capital reserve', the proportion thereof applicable to the outside shareholders of A Ltd. *should* be credited to minority interest, as it represents part of the value of the net assets shown in the consolidated accounts which is attributable to their holdings. Thus, in the above example, if the price paid by A Ltd. for the shares in B Ltd. had been only £10,000, there would have been a 'capital reserve' of £2,000, of which £500 would be credited to the minority interest in B, and the balance of £1,500 deducted from the consolidated goodwill. Alternatively the 'capital reserve' could be applied in writing down the assets of B Ltd. for the purpose of the consolidated accounts.

In the preceding illustration the shares in B Ltd. were acquired by Holding Ltd. and A Ltd. on the same date.

Where shares in a subsidiary have been acquired by different members of the group at different dates, the 'goodwill' element in respect of each holding will be represented by the excess of the cost thereof over the proportion of the net assets of the subsidiary attributable thereto at the date of the particular acquisition. Any undivided profits of such subsidiary which have accrued *after* the acquisition will be revenue profits from the viewpoint of that holding member. If, however, such holding member later becomes a subsidiary of the parent company, the proportion of the post-acquisition profits of the first mentioned subsidiary attributable to that holding member, will constitute part of its net assets at the date on which it, in turn, became a subsidiary of the parent company, and must be treated as a pre-acquisition profit in computing the 'goodwill' ingredient of the parent company's holding.

Illustration (12)

The following schedules summarise the Balance Sheets, as on 31st December, of a group of companies:

	X Ltd.	Y Ltd.	Z Ltd.
	£	£	£
Land and Buildings ..	125,000	71,700	16,000
Plant and Machinery ..	175,000		16,500
Fixtures and Fittings ..	15,000	6,000	2,500
Investments:			
Y Ltd. 120,000 shares ..	105,000		
Z Ltd. 20,000 shares ..	14,000		
„ 10,000 shares ..		7,000	
Stock in trade:	150,460	46,655	24,500
Sundry Debtors:			
General	37,450	28,300	8,500
Y Ltd.	15,685		
Z Ltd.	15,985	8,750	
Cash and Bank Balances ..	25,200	1,350	2,315
Profit and Loss Account balance			5,000
	£678,780	£169,755	£75,315
Capital, issued in shares of £1 each:			
Fully paid up	500,000		50,000
15s. paid up (160,000 shares)		120,000	
General Reserves .. .	100,000	20,000	
Profit and Loss Account balances .	51,500	5,000	
Sundry Creditors:			
General	27,280	12,070	1,830
X Ltd.		12,685	15,985
Y Ltd.			7,500
	£678,780	£169,755	£75,315

On 31st December, goods to the value of £3,000 were in transit from X Ltd. to Y Ltd. and a remittance of £1,250 from Z Ltd. to Y Ltd. was not recorded by the latter company until after the books had been closed.

Y Ltd. had a credit balance on Profit and Loss Account of £10,000, and no General Reserve, when it became a subsidiary of X Ltd., but has since paid dividends of £20,000, of which £10,000 was paid out of pre-acquisition profits. X Ltd. has taken credit for its share of these dividends in its Profit and Loss Account.

Z Ltd. had a debit balance on Profit and Loss Account of £15,000 when Y Ltd. purchased 10,000 shares, and of £10,000 when later, X Ltd. purchased 20,000 shares in Z Ltd. X Ltd. purchased its holdings in Y Ltd. and Z Ltd. on the same date.

You are required to prepare a Consolidated Balance Sheet for the group as at 31st December. Ignore Taxation.

Notes as to consolidating adjustments:

(*a*) The dividends received by X Ltd. from Y Ltd. amount to $\frac{3}{4}$ of £20,000 = £15,000 of which £7,500 was paid out of pre-acquisition profits, and must therefore be transferred from X Ltd.'s Profit and Loss Account to the credit of Shares in Y Ltd. Account (or Goodwill Account).

(*b*) The pre-acquisition losses of Z Ltd. which must be transferred from Z Ltd.'s Profit and Loss Account to the *debit* of Goodwill, are:

			£
re Y Ltd.'s holding — $\frac{1}{5}$th of £15,000	..	=	3,000
re X Ltd.'s holding — $\frac{2}{5}$ths of £10,000			4,000
			£7,000

(*c*) Since Z Ltd.'s debit balance on Profit and Loss Account was £15,000 when Y Ltd. acquired its holding and £10,000 when X Ltd. acquired its holding in Z Ltd., and is now £5,000, Z Ltd. has made *profits* as follows:

(i) £10,000 since Y Ltd.'s acquisition, of which £5,000 was earned before Y Ltd. became a subsidiary of X Ltd.;

(ii) £5,000 since X Ltd.'s acquisition.

(*d*) In respect of (*c*) (i) one-fifth — £2,000 is attributable to Y Ltd.; of this amount £1,000 was earned prior to Y Ltd. becoming a subsidiary of X Ltd. and thus constitutes a pre-acquisition profit of which three-fourths = £750 relates to X Ltd.'s holding in Y Ltd. and must be credited to goodwill.

In respect of (*c*) (ii) two-fifths — £2,000 is a post-acquisition profit of X Ltd.

(*e*) Y Ltd.'s minority shareholders must be credited with one-fourth of Y Ltd.'s profits (including that company's share of the post-acquisition profits of Z Ltd.). Z Ltd.'s outside shareholders must be *debited* with two-fifths of that company's debit balance on Profit and Loss Account of £5,000.

CONSOLIDATING JOURNAL ENTRIES

		£	£
Shares in Y Ltd.	*Dr.*	7,500	
To Profit and Loss Account, X Ltd.			7,500
Writing back dividend paid by Y Ltd out of pre-acquisition profits (See Note (*a*) above)			
Goodwill, X Ltd.		97,500	
To Shares in Y Ltd. . ..			97,500
Goodwill, X Ltd .		14,000	
To Shares in Z Ltd .			14,000
Goodwill, Y Ltd. .		7,000	
To Shares in Z Ltd.			7,000
Transfer of cost of shares in subsidiaries.			
Share Capital, Y Ltd.	*Dr*	120,000	
To Goodwill, X Ltd.			90,000
,, Minority Interest, Y Ltd.			30,000
Share Capital, Z Ltd	*Dr*	50,000	
To Goodwill, X Ltd			20 000
,, ,, Y Ltd.			10,000
,, Minority Interest, Z Ltd. .			20,000
Transfer of nominal value of shares.			
Goodwill, Y Ltd.		3,000	
To Profit and Loss Account, Z Ltd. .. .			3,000
Transfer of pre-acquisition loss of Z Ltd., attributable to Y's holding in Z (1/5th of £15,000).			
Profit and Loss Account, Z Ltd. .		2,000	
To Profit and Loss Account, Y Ltd. .			2,000
Transfer of post-acquisition *profit* of Z Ltd attributable to Y's holding (1/5th of £10,000)			
Goodwill, X Ltd.	*Dr.*	4,000	
To Profit and Loss Account, Z Ltd. .			4,000
Transfer of pre-acquisition loss of Z Ltd. attributable to X Ltd (2/5ths £10,000)			
Profit and Loss Account, Z Ltd. . .	*Dr.*	2,000	
To Profit and Loss Account, X Ltd. .. .			2,000
Transfer of post-acquisition *profit* of Z Ltd. attributable to X Ltd. (2/5ths £5,000).			
Profit and Loss Account, Y Ltd. .	*Dr.*	750	
To Goodwill, X Ltd			750
Transfer of pre-acquisition profit of Y Ltd. attributable to X Ltd. (see Note (*d*) above).			
Profit and Loss Account, Y Ltd.		4,500	
To Profit and Loss Account, X Ltd.			4,500
Transfer of post-acquisition profit of Y Ltd. attributable to X Ltd. (3/4ths · £6,000)			

CONSOLIDATING JOURNAL ENTRIES (*continued*)

		£	£
General Reserve, Y Ltd. ..	Dr.	5,000	
Profit and Loss Account, Y Ltd.		1,750	
To Minority Interest, Y Ltd. ..			
Transfer of shares of Reserve (1/4th × £20,000) and profit (1/4th × £7,000) attributable to outside shareholders of Y Ltd.			
Minority Interest, Z Ltd.	Dr.	2,000	
To Profit and Loss Account, Z Ltd.			
Transfer of share of debit balance attributable to outside shareholders of Z Ltd. – (2/5ths × £5,000).			
Profit and Loss Account, X Ltd. ..	Dr.	50,500	
To Consolidated Profit and Loss Account			50,500
Transfer of balance.			
Goods in transit ..		3,000	
Cash in transit .		1,250	
To Current Account, Y Ltd. .			3,000
„ Current Account, Z Ltd. .			1,250
Adjustments for value in transit.			
Y Ltd Current Account (X) ..	Dr.	12,685	
Z Ltd. Current Account (Y)		7,500	
To X Ltd. Current Account (Y)			12,685
„ Y Ltd. Current Account (Z)			7,500
Setting off inter-company balances.			

The consolidating ledger accounts will appear as follows:

GOODWILL

	£		£
To Shares in Y Ltd. held by X Ltd.	105,000	By Y Ltd. Share Capital, nominal value	90,000
Less Dividend paid out of pre-acquisition profits	7,500	„ Profit and Loss Account, Y Ltd. Pre-acquisition profit . ..	750
	97,500	„ Balance = Goodwill .	6,750
	£97,500		£97,500
To Shares in Z Ltd. held by X Ltd.	14,000	By Z Ltd. Share Capital, nominal value	20,000
„ Z Ltd. Profit and Loss Account – pre-acquisition loss	4,000		
„ Balance – Capital Reserve	2,000		
	£20,000		£20,000
To Shares in Z Ltd. held by Y Ltd.	7,000	By Z Ltd. Share Capital, nominal value	10,000
„ Z Ltd. Profit and Loss Account – pre-acquisition loss	3,000		
	£10,000		£10,000

Note. It is preferable to set off the 'capital reserve' arising from the purchase by X Ltd. of shares in Z Ltd. against the goodwill purchased in Y Ltd. The goodwill appearing in the consolidated Balance Sheet will thus be:

	£
Goodwill in Y Ltd. (as above)	6,750
Less Capital Reserve in Z Ltd.	2,000
	£4,750

Since the price paid by Y Ltd. for its holding in Z Ltd. (£7,000) is exactly equal to the net assets of Z Ltd. attributable thereto (share capital £10,000 less pre-acquisition loss £3,000) no goodwill or capital reserve arises in respect of this holding.

PROFIT AND LOSS ACCOUNT, X LTD.

	£		£
To Goodwill – Dividend from Y Ltd. paid out of pre-acquisition profit	7,500	By X Ltd. – Balance b/f. .	51,500
" Balance to Consolidated Profit and Loss Account	50,500	" Y Ltd. – Post-acquisition profit	4,500
		" Z Ltd. – Post-acquisition profit	2,000
	£58,000		£58,000

PROFIT AND LOSS ACCOUNT, Y LTD.

	£		£
To Minority Interest (¼ × £7,000) .. .	1,750	By Balance b/f ..	5,000
" Goodwill (¾ × £1,000) being Y Ltd.'s share of Z Ltd.'s profit earned between date of acquisition by Y Ltd. of shares in Z Ltd. and date on which Y Ltd. became a subsidiary of X Ltd...	750	" Share of post-acquisition profit of Z Ltd (⅕th × £10,000)	2,000
" Balance to Consolidated Profit and Loss Account	4,500		
	£7,000		£7,000

PROFIT AND LOSS ACCOUNT, Z LTD.

	£		£
To Balance b/f.	5,000	By Minority Interest (⅖th of £5,000)	2,000
" Y Ltd. Profit and Loss Account – Share of profit attributable to Y Ltd. since acquisition (⅕th of £10,000)	2,000	" Goodwill.	
		re Y Ltd.'s holding (⅕ × £15,000)	3,000
		re X Ltd.'s holding (⅖ × £10,000)	4,000
" X Ltd. Profit and Loss Account – Share of profit attributable to X Ltd. since acquisition (⅖ths of £5,000)	2,000		
	£9,000		£9,000

MINORITY INTERESTS

	Y Ltd. £	Z Ltd. £		Y Ltd. £	Z Ltd. £
To Profit and Loss Account, 2/5ths × £5,000 .. .		2,000	By Share Capital	30,000	20,000
" Balances per Consolidated Balance Sheet . .	36,750	18,000	" General Reserve, 1/4th × £20,000	5,000	
			" Profit and Loss Account 1/4th × £7,000	1,750	
	£36,750	£20,000		£36,750	£20,000

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Share Capital .. .		500,000	Goodwill .		4,750
General Reserve:			Land and Buildings:		
X Ltd.	100,000		X Ltd.	125,000	
Y Ltd. (¾ × £20,000) .. .	15,000		Y Ltd.	71,700	
		115,000	Z Ltd.	16,000	
Consolidated Profit and Loss Account		50,500			212,700
		665,500	Plant and Machinery:		
Minority Interests		54,750	X Ltd ..	175,000	
			Z Ltd	16,500	
					191,500
Creditors.			Fixtures and Fittings:		
X Ltd. .	27,280		X Ltd. .. .	15,000	
Y Ltd.	12,070		Y Ltd.	6,000	
Z Ltd. ..	1,830		Z Ltd.	2,500	
					23,500
		41,180	Stock-in-Trade.		
			X Ltd. .	150,460	
			Y Ltd. .	46,655	
			Z Ltd. .. .	24,500	
			In transit	3,000	224,615
			Sundry Debtors:		
			X Ltd. . .	37,450	
			Y Ltd. .	28,300	
			Z Ltd.	8,500	74,250
			Cash and Bank Balances		
			X Ltd.	25,200	
			Y Ltd. ..	1,350	
			Z Ltd. . ..	2,315	
			In Transit	1,250	30,115
		£761,430			£761,430

(m) Shares in Holding Company held by Subsidiary Company

As from 1st July 1948, any allotment of shares by a holding company to its subsidiary company is void, and a subsidiary cannot acquire shares in its holding company. A subsidiary which was a member of its holding company at the commencement of the Act may, however, continue to be a member of it, but has no right to vote at meetings. Where shares in its holding company are held by a subsidiary, the *nominal* value of such shares should be deducted from the issued share capital of the holding company and any premium paid on the purchase should be deducted in the consolidated Balance Sheet from Share Premium Account or Reserve (if one exists) or otherwise added to goodwill. Where, however, there were undistributed profits in the holding company's books at the date of acquisition of the shares the proportion of such profits attributable to the subsidiary company's holding should be deducted in the parent company's Profit and Loss Account and also from the cost of the shares before making the transfer to goodwill.

Illustration (13)

	H	S		H	S
	£	£		£	£
Capital	25,000	10,000	90% interest in S at cost . ..	11,000	
Profit and Loss Account	4,000	2,400	Sundry Assets . .	20,000	7,400
Creditors	2,000	1,000	20% interest in H at cost		6,000
	£31,000	£13,400		£31,000	£13,400

S acquired its holding in H when H had a credit balance on Profit and Loss Account of £1,600.

Later, H acquired its holding in S when S had a credit balance of £800 and H a credit balance of £3,000 on Profit and Loss Account.

(*a*) The pre-acquisition profits will be as follows:

	£	£
(i) On purchase by S of shares in H:		
20% of £1,600 (being balance on H's Profit and Loss Account) ..		320
(ii) On purchase by H of shares in S:		
Amount attributable to group:		
90% of £800 (being balance on S's Profit and Loss Account) ..	720	
90% of £280 (being proportion of balance on H's Profit and Loss Account at this date which is attributable to S's holding in H and thus forms part of S's profit, *viz.*, 20% of £3,000 = £600, less £320 as in (i) above	252	
		972
		1,292
Amount attributable to outside shareholders of S:		
10% of £800 (*see* (ii) above)	80	
10% on £280 (*see* (ii) above)	28	
		108
		£1,400

(*b*) The cost of the respective goodwills will therefore be:

		S		H
Cost of shares acquired		£6,000		£11,000
Less Nominal value	£5,000		£9,000	
Pre-acquisition profits as above	320		972	
		5,320		9,972
		£680		£1,028

(*c*) The profits earned since the acquisition are:

	S	H
Profits per Balance Sheets .. .	£2,400	£4,000
Less Balances at dates of acquisition .	800	3,000
	£1,600	£1,000

Before computing the proportion of S's profit which is ascribable to the minority interests in that company, however, S's profit must be increased by that company's share of H's profit and reduced by H's share of S's profit.

The amount may be calculated as follows:

Let H = total profit of H (including share of S's profit):

Let S = total profit of S (including share of H's profit):

$$\text{Then } H = £1{,}000 + \tfrac{9}{10}S \text{ and } S = £1{,}600 + \tfrac{1}{5}H.$$
$$\therefore\ 10\,H = £10{,}000 + 9\,S \text{ and } 50\,S = £80{,}000 + 10\,H.$$
$$\therefore\ 50\,S = £90{,}000 + 9\,S.$$
$$\therefore\ 41\,S = £90{,}000$$
$$\therefore\ S = £2{,}195$$

The minority shareholders' proportion is therefore 10% of £2,195 = £219·5 (say £220).
The *total* amount of S's profit attributable to the minority interests will thus be:

Share of pre-acquisition profit (*see* (*a*) (ii)	£108
Share of post-acquisition profit (as above)	220
	£328

(*d*) The consolidated Profit and Loss Account will be as follows:

	£	£	£
Profit and Loss Account of H		4,000	
Less Transfer to goodwill (*see* (*a*) (i))	320		
Transfer to goodwill (*see* (*a*) (ii)) ..	252		
		572	
			3,428
Profit and Loss Account of S ..		2,400	
Less Transfer to goodwill (*see* (*a*) (ii))		720	
			1,680
			5,108
Less Proportion attributable to minority interests (*see* (*c*))			328
			£4,780

The total profits are thus apportioned as follows:

Pre-acquisition profits of group (*a*) ..	£1,292
Minority interests (*c*)	328
Holding company (*d*)	4,780
	£6,400

CONSOLIDATED BALANCE SHEET

	£	£		£	£
Capital ..	25,000		Goodwill, etc., H .	680	
Less held by S ..	5,000		" S	1,028	
		20,000			1,708
Profit and Loss Account ..		4,780	Sundry Assets H .	20,000	
Minority Interests in S:			" S .	7,400	
Capital	1,000				27,400
Undistributed Profits	328				
		1,328			
Creditors H	2,000				
" S	1,000				
		3,000			
		£29,108			£29,108

It will be seen that the above calculations proceed on the basis of each company distributing its profits up to the hilt, *i.e.*, each £ distributed by one company increases the other company's profits, of which a share is due to the first company, and so on *ad infinitum* While this is theoretically correct, the authors regard it as too pedantic. The true position in the above case is that the combined profits are:

S	£1,600
H	1,000
	£2,600

In the opinion of the authors, it is sufficient to reserve for the minority interest on post-acquisition profits on the following basis:

Profits of S as they stand	£1,600
Dividend that would be received by S if H declared the whole of its profits as dividend: 1/5th × £1,000 ..	200
	£1,800
10% of £1,800 =	£180

A note can be added to the effect that: 'In arriving at the share of minority shareholders in the profits made since the shares in the subsidiary company were acquired by the holding company, no account has been taken of the inflation of profits that would arise if each company distributed its profits fully (thus creating additional paper profits in which the other would be entitled to a share, which in turn would be distributed).'

(n) Foreign Subsidiaries

Foreign subsidiaries raise special problems, particularly where exchange restrictions prevent the remittance of money to the United Kingdom. If current and liquid assets of the subsidiary company are included in the consolidated Balance Sheet, not only is it difficult to decide upon a rate of exchange for their conversion into sterling, but,

since no use of the funds can be made here, a most misleading statement may result. Where subsidiaries operate in many foreign countries, the problem is magnified, and it is suggested that, in general terms, it is better to keep separate from the other assets and liabilities the balances applicable to subsidiary companies operating in countries with 'frozen' exchanges, or even to exclude such companies from consolidation.

Great care must be taken in all cases of foreign subsidiary companies to ensure that any unrealised profits are eliminated in the consolidated Balance Sheet, *e.g.*, where the holding company in this country has sold goods to the foreign subsidiary. In such a case, the 'sale' will have been credited, normally, at the usual selling price, and taken in by the subsidiary at the currency equivalent on the date of delivery. In valuing its stock for the purposes of its Balance Sheet, the subsidiary will have valued any such goods at cost or market price, whichever is lower, and, according to the rules normally adopted for conversion, this value will be converted into sterling at the rate ruling at the date of the Balance Sheet. Not only therefore is there an unrealised profit (from the viewpoint of the group) in the stock-in-hand which emanated from the holding company, but there may be a fictitious profit or loss on exchange arising through the difference between the rates of exchange on the dates of delivery and of the Balance Sheet respectively. Adjusting entries must therefore be made in the process of preparing the consolidated Balance Sheet, to ensure that the stock does not appear in the consolidated Balance Sheet at more than its cost to the group.

In other respects, the conversion of currency into sterling follows generally the same rules as in Branch Accounts (*see* Chapter X).

Fixed assets of foreign subsidiaries should appear in the consolidated Balance Sheet at their sterling cost, which must, therefore, be recorded as and when each asset is acquired. In regard to any new fixed assets acquired during an accounting period these should be converted at the rates in force at the dates when the remittances from the holding company were made, or, if the assets were purchased out of the subsidiary's own resources, at the rates in force at the dates of purchase. Where, however, the rates of exchange have not fluctuated materially during the year, the cost of additions may be converted at the average rate for the period.

An adjustment may be necessary in respect of depreciation of fixed assets. The depreciation will be converted at the rate ruling at the date that the expenditure on the asset was incurred, which may differ greatly from current rates. If the effect is that the aggregate depreciation on all subsidiary companies' assets, as converted into sterling on this basis, is considerably less than it would be on a current rate basis, there may be a serious paper inflation of profits, since the apparent profit may exceed the sterling equivalent of the money which would be remitted in payment of a dividend equal to the whole currency profit. A special provision should be created, or it may be considered whether consolidation should be made at all in the circumstances.

Exchange differences on conversion may never be realised; they may be wholly in respect of capital items, etc., and until realised on remittance should, if profits, be credited to reserve or, if losses, be written off.

§ 5. Consolidated Profit and Loss Account

As has already been stated, the group accounts laid before a holding company will normally comprise a consolidated Profit and Loss Account as well as a consolidated Balance Sheet, and the provisions of Part I of the Eighth Schedule, as to the matters to be disclosed in a company's Profit and Loss Account (*see* page 347), except that Sections 196 and 197 of the Act (which relate to the disclosure in the accounts laid before the members of emoluments, etc., paid to directors, and loans to officers, etc.), apply also to a consolidated Profit and Loss Account.

The preparation of a consolidated Profit and Loss Account follows similar lines to a consolidated Balance Sheet, all the information contained in the separate Profit and Loss Accounts of the respective companies being combined together and set out under appropriate headings, after eliminating inter-company transactions.

In consolidating the Profit and Loss Accounts, particular attention must be paid to the following matters:

(*a*) *Pre-acquisition profits or losses*

Where the balance brought forward in a subsidiary's Profit and Loss Account includes any profit or loss which arose prior to the acquisition of the shares therein by the holding company, the amount thereof applicable to the holding company must be eliminated and transferred to goodwill as already explained. It will thus be taken into account in computing the sum attributable to goodwill in the consolidated Balance Sheet.

Similarly, if the shares in the subsidiary were acquired during the year to which the Profit and Loss Account relates, the profit for the year must be apportioned to the date of acquisition, and the pre-acquisition profit transferred to goodwill.

(*b*) *Inter-company unrealised profits*

The proportion affecting the members of the holding company of the profit included in the price at which any stock-in-hand at the date of the accounts has been transferred from one company to another, must be deducted from the trading profit in the consolidated Profit and Loss Account, and from the stock valuation in the consolidated Balance Sheet. Similarly, any unrealised profit included in the price at which any fixed assets have been transferred from one company in the group to another must be deducted from the profit and from the value of the asset.

It has already been seen that from the point of view of any minority shareholders in a subsidiary, the inter-company profit must be regarded as realised, whether it operates for or against the particular subsidiary. Thus, if H Ltd. holds 90% of the ordinary capital of S Ltd., in respect of any profit included in the invoice price of goods sold by S Ltd. to H Ltd., which are still held by H Ltd., only 90% will be deleted; the remaining 10% is a realised profit from the viewpoint of the minority shareholders. Similarly, if H Ltd. has sold goods to S Ltd., which are still in stock, only 90% of the profit thereon will be eliminated; the other 10% is tantamount to a profit earned by H Ltd. on a sale to the outside members of S Ltd.

(c) Inter-company dividends

A dividend paid by a subsidiary to its holding company will appear as a debit in the Profit and Loss Account of the subsidiary and as a credit in that of the holding company. In the consolidated Profit and Loss Account, therefore, the dividend will cancel out.

It must, however, be remembered that the dividend will normally have been debited *net* in the accounts of the subsidiary, whereas it will have been credited *gross* in the accounts of the holding company, the income tax suffered by deduction thereon having been debited to the holding company's Taxation Account. It will therefore be necessary to deduct the *net* inter-company dividend from the dividends debited in the subsidiary's Profit and Loss Account, and the income tax thereon from the debit for taxation in the holding company's Profit and Loss Account, whilst the *gross* dividend will be deducted from the holding company's income from investments on the credit side of the account.

If a dividend received by the holding company, and credited to its Profit and Loss Account, is found to have been paid by the subsidiary out of pre-acquisition profits, the *net* amount thereof must be transferred from the Profit and Loss Account to the credit of the shares in the Subsidiary Company Account. Any such dividend should not have been treated as revenue by the holding company, as it is paid out of assets which are included in the property forming the underlying security for the shares acquired by the holding company, and as such must be regarded as reducing the price of the shares. In effect, the shares were purchased *cum div.*, and the dividend included in the price must, when received, be treated as capital.

Dividends paid or payable to outside shareholders by a subsidiary may either be shown as such in the consolidated Profit and Loss Account, or included without distinction in the amount of profit attributable to minority interests. The latter method is the more usual.

(d) Transfers to reserves, etc.

Only such proportion of any sum transferred to reserve by a subsidiary, as is attributable to the holding company's interest in that subsidiary will be added to any sums transferred to reserve by the holding company and debited to the consolidated Profit and Loss Account. The proportion of any such transfer attributable to minority interests will be included in their share of the undistributed profits of subsidiaries.

(e) Depreciation Adjustments

As explained in illustration § 4 (*k*) of this chapter, where any fixed assets of a subsidiary have been revalued for the purpose of the consolidated accounts, the charge for depreciation in the consolidated Profit and Loss Account may require adjustment. Where, for example, the value of a fixed asset has been written up above the figure at which it appears in the subsidiary's books, the charge for depreciation to the consolidated Profit and Loss Account must be increased by depreciation at the appropriate rate on the increase in value; where the value of the asset has been written down, the charge for depreciation must be proportionately reduced. Similarly, if

plant has been purchased by one company from another at a profit, the profit must be eliminated and the charge for depreciation reduced by the amount applicable to the amount by which the value of the asset has been reduced.

(f) Minority Interests

The share of a subsidiary's profit or loss attributable to minority interests will be made up of:

(*a*) the appropriate proportion of the balance brought forward from the previous year;

(*b*) The appropriate proportion of the profit or loss for the year, before debiting dividends, and transfers to reserve.

(*c*) Alternatively the dividends applicable to minority interests may be debited separately to the consolidated Profit and Loss Account, in which case all dividends will be deducted from profit before computing the proportion thereof applicable to the minority interests.

Where method (*b*) is employed, the amount of the undistributed profit attributable to minority interests appearing in the consolidated Balance Sheet will consist of (*a*) plus (*b*) less the amount of any dividends actually paid during the year to the minority shareholders. Where method (*c*) is followed, the liability to minority interests will be (*a*) plus (*c*), plus the amount of any *proposed* dividends payable to minority interests

Illustration

The summarised Profit and Loss Accounts of A Ltd. and its subsidiaries B Ltd. and C Ltd for the years ended 31st December, 19.. are as follows:

PROFIT AND LOSS ACCOUNT

	A		C
	£		£
To Balance b/f. ..			10,000
" Depreciation written off ..	20,000	15,000	8,000
" Directors' Emoluments ..	10,000	5,000	2,000
" Debenture Interest (gross amount)	5,000	3,000	2,000
" Taxation ..	23,142	12,535	
" Transfer to Reserve	10,000	5,000	
" Transfer to Debenture Redemption Fund .	3,000	1,500	
" Interim Dividends paid (net):			
Preference ..	575	288	
Ordinary .	(5%) 2,875	(4%) 920	
Final Dividends proposed (net):			
Preference ..	575	287	
Ordinary ..	(20%) 11,500	(10%) 2,300	
" Balance c/d. ..	23,850	7,080	
	£110,517	£52,910	£22,000

	A	B	C
	£	£	£
By Balance b/f.	15,500	7,000	—
" Trading Profit for year ..	87,817	45,460	16,000
" Interest on Government Securities (gross) ..	3,000	450	
" Dividends from B Ltd. (gross):			
Interim	1,200		
Proposed Final .	3,000		
" Balance c/f. ..			6,000
	£110,517	£52,910	£22,000

You are given the following information:

(1) The share capital of the companies consists of:

	A Ltd.	B Ltd.	C Ltd.
	£	£	£
£1 5% Cumulative Preference Shares	40,000	20,000	
£1 Ordinary Shares	100,000	40,000	10,000

(2) A Ltd. holds 30,000 of the ordinary shares of B Ltd., and 9,000 of the ordinary shares of C Ltd. The whole of the preference shares of B Ltd. are held outside the group.

(3) At the dates on which A Ltd. acquired its holdings, B Ltd. had a credit balance on Profit and Loss Account of £5,000 and C Ltd. a debit balance on Profit and Loss Account of £12,000. All dividends have been paid out of current earnings.

(4) A Ltd.'s stock includes goods purchased from B Ltd. for £5,200, invoiced by B Ltd. at cost plus 33⅓%.

(5) For the purpose of the consolidated Balance Sheet, B Ltd.'s plant was valued at £10,000 above its book value. Depreciation for the year had been provided for by B Ltd. at 10% per annum on the book value.

(6) Part of C Ltd.'s plant had been purchased from A Ltd. (who manufactured it) at a profit to that company of £1,000 which is included in its trading profit for the current year. No depreciation had been written off this plant by C Ltd. during the year.

You are required to prepare a consolidated Profit and Loss Account for the year ended 31st December, 19... Income tax is to be taken into account at 8s. 6d. in £.

The figures for inclusion in the consolidated Profit and Loss Account are computed as follows:

Balance brought forward:

	A Ltd.	B Ltd.		C Ltd.		Total	
	£	£	£	£	£	£	£
Amount per Profit and Loss Account	15,500		7,000		*Dr.* 10,000		12,500
Less Minority Interest . .		(¼th)	1,750	(1/10th)	1,000		750
			5,250		9,000		11,750
Deduct Pre-acquisition Profit transferred to Goodwill		5,000		*Dr.* 12,000			
Less Minority Interest		1,250		1,200			
			3,750		10,800		7,050
	£15,500		£1,500		£1,800		£18,800

Trading Profit:

		A Ltd.	B Ltd.		C Ltd.	Total
Amount as per Profit and Loss Account		87,817		45,460	16,000	149,277
Deduct Profit on Sale of Plant to C Ltd.	£1,000					
Less Minority Interest (1/10th)	100					
		900				
Profit on Sale of Goods to A Ltd.: 25% on £5,200			1,300			
Less Minority Interest (¼) ..			325			
				975		1.875
		£86,917		£44,485	£16,000	£147.402

Depreciation:	A Ltd. £	B Ltd. £	C Ltd. £	Total £
Amount as per Profit and Loss Account	20,000	15,000	8,000	43,000
Add 10% on £10,000 increase in valuation		1,000		1,000
	£20,000	£16,000	£8,000	£44,000

Taxation:				
Amount as per Profit and Loss Account	23,142	12,535		35,677
Deduct Tax on dividend of £4,200 from B Ltd.	1,785			1,785
	£21,357	£12,535		£33,892

Transfer to Reserve:				
As per Profit and Loss Account	10,000	5,000		15,000
Deduct Minority Interest (¼th)		1,250		1,250
	£10,000	£3,750		£13,750

Transfer to Debenture Redemption Fund	3,000	1,500		4,500
Deduct Minority Interest (¼th) ..		375		375
	£3,000	£1,125		£4,125

Proportion of Profit for year attributable to Minority Interest:

	B Ltd. £	B Ltd. £	C Ltd. £	C Ltd. £	Total £
Trading Profit		45,460		16,000	
Interest on Government Securities		450			
		45,910			
Deduct Depreciation	16,000		8,000		
Directors' Emoluments	5,000		2,000		
Debenture Interest	3,000		2,000		
Taxation	12,535				
Preference Dividend	575				
		37,110		12,000	
		£8,800		£4,000	

		B Ltd.		C Ltd.	Total
		£		£	£
Attributable to Ordinary Shareholders	($\frac{1}{4}$th)	2,200	($\frac{1}{10}$)	400	2,600
Attributable to Preference Shareholders		575			575
		£2,775		£400	£3,175

CONSOLIDATED PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31st DECEMBER, 19..

		£		£
To Depreciation ..		44,000	By Trading Profit for year	147,402
" Directors' Emoluments		17,000	" Interest on Quoted Investments	3,450
" Debenture Interest		10,000		
" Taxation ..		33,892		
" Proportion of Profit for year applicable to Minority Interest ..		3,175		
" Group Profit for year c/d.		42,785		
		£150,852		£150,852
To Transfer to Reserve		13,750	By Group Profit for year b/d.	42,785
" " " Debenture Redemption Fund ..		4,125	" Balance brought forward from previous year	18,800
" Interim Dividends paid (*less* tax):				
Preference	£575			
Ordinary .	2,875			
		3,450		
" Final Dividends proposed (*less* tax):				
Preference .	£575			
Ordinary . . .	11,500			
		12,075		
" Balance to Consolidated Balance Sheet		28,185		
		£61,585		£61,585

Alternatively, the consolidated Profit and Loss Account might be presented as follows:

	£	£
Trading Profit for year		76,402
after charging:		
Depreciation	44,000	
Directors' Emoluments	17,000	
Debenture Interest	10,000	
	£71,000	
Income from Quoted Investments . .		3,450
Profit for year before Taxation.. .. .		79,852
Deduct United Kingdom Taxation		33,892
Profit for year after Taxation		45,960
Deduct Proportion applicable to Minority Interest		3,175
Profit for year applicable to group		42,785
Add Balance brought forward from previous year		18,800
	c/f.	61,585

		b/f.	£61,585
Deduct Appropriations:			
Transfer to Reserve		£13,750	
„ „ Debenture Redemption Fund		4,125	
Interim Dividends paid (*less* tax):			
Preference	£575		
Ordinary	2,875		
		3,450	
Final Dividends proposed (*less* tax):			
Preference	£575		
Ordinary	11,500		
		12,075	
			33,400
Balance carried to Consolidated Balance Sheet			£28,185

Note. In the consolidated Balance Sheet, the liability to minority interests in respect of undistributed profits will be made up as follows:

		B Ltd.	C Ltd.	Total
		£	£	£
Balance brought forward .		1,750	*Dr.* 1,000	750
Profit for year		2,775	400	3,175
		4,525	*Dr.* 600	3,925
Less Interim Dividends paid:				
Preference .. .	£288			
Ordinary .	230			
		518		518
		£4,007	*Dr.* £600	£3,407

Note. These figures include the outside shareholders' proportion of the sums transferred by B Ltd. to Reserve and to the Debentures Redemption Fund Account, which is itself a form of reserve. They also include the proposed preference and ordinary dividends payable to outside shareholders. It may be preferred to show these separately as a liability in the consolidated Balance Sheet.

§ 6. Holding Company's Profit and Loss Account framed as a Consolidated Profit and Loss Account

By Section 149, Companies Act, 1948, a holding company which publishes a consolidated Profit and Loss Account need not also publish its own Profit and Loss Account, provided that the consolidated Profit and Loss Account:

(i) complies with the requirements of the Act relating to Consolidated Profit and Loss Accounts; and

(ii) shows how much of the consolidated profit or loss *for the financial year* is dealt with in the accounts of the company.

Since a holding company normally takes credit in its own accounts only for dividends paid and proposed by its subsidiaries, and not for its full share of the profits

earned by them, in order to satisfy the second of the above requirements there must be deducted from the consolidated profit appropriate to the holding company such amount thereof as is retained and carried forward in the accounts of the subsidiaries.

The resultant balance will be transferred to the holding company's Appropriation Account, in which that company's own balance of Profit and Loss Account brought forward, and dividends paid and proposed and other appropriations will be entered. The final balance is that which will appear in the holding company's *own* Balance Sheet (not in the consolidated Balance Sheet).

Illustration

The Profit and Loss Accounts of A Ltd. and its Subsidiaries B Ltd. and C Ltd. for the year ended 31st March, 1959, are as follows:

	A Ltd	B Ltd.	C Ltd		A Ltd.	B Ltd.	C Ltd
	£	£	£		£	£	£
To Depreciation	8,000	3,000	4,000	By Trading Profit	50,000	20,000	25,000
„ Directors' Emoluments	10,000	5,000	3,000	„ Income from Quoted Securities (gross)	5,000	1,000	1,500
„ Taxation ..	18,000	6,000	9,000	„ Dividend from B Ltd. (gross)	3,000		
„ Profit for year c/d.	26,000	7,000	10,500	„ Dividend from C Ltd (gross)	4,000		
	£62,000	£21,000	£26,500		£62,000	£21,000	£26,500
„ Dividends (net)..	11,500	2,300	2,875	By Profit for year b/d.	26,000	7,000	10,500
„ Balances c/f. ..	36,500	10,700	15,625	„ Balance from last year	22,000	6,000	8,000
	£48,000	£13,000	£18,500		£48,000	£13,000	£18,500

A Ltd. holds 75% of the Share capital of B Ltd. and 80% of that of C Ltd. each of whom had paid a dividend of 10 per cent. during the year, out of the current year's profit, for which credit had been taken by A Ltd. in its accounts. There were no other inter-company transactions.

Prepare A Ltd.'s Profit and Loss Account framed as a consolidated Profit and Loss Account to comply with Section 149, Companies Act, 1948.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 1959

	£	£
Trading Profit for year,		62,000
after charging Depreciation .	15,000	
Directors' Remuneration	18,000	
	£33,000	
Income from Quoted Investments		7,500
Profit for year before taxation .		69,500
Less Taxation (*Note* 1)		30,025
Profit for year after taxation . ..		39,475
Less Proportion attributable to Minority Interest ((*Note* 2)		3,850
Group Profit for year		35,625
Less Profit for year retained by subsidiaries attributable to group (*Note* 3)		9,625
Group Profit for financial year dealt with in the accounts of A Ltd		26,000
Add Balance brought forward .		22,000
		48,000
Deduct Dividends, *less* tax		11,500
Balance on Profit and Loss Account carried forward by A Ltd. ..		36,500
Add Total Profits retained by subsidiaries attributable to the group		20,525
Balance carried forward in Consolidated Balance Sheet		£57,025

Notes:

(1) The charge for Taxation is the aggregate of the sums debited in respect of taxation in the Profit and Loss Accounts, £33,000, less £2,975 Income Tax included therein on the £7,000 Dividends from subsidiaries credited to A Ltd.'s Profit and Loss Account.

(2) The profits attributable to minority interests are:

	£
B Ltd. 25% of £7,000	1,750
C Ltd. 20% of £10,500	2,100
	£3,850

(3) The profits retained by subsidiaries attributable to the group are:

		B Ltd.		C Ltd.	
		£		£	
Profit for year		7,000		10,500	
Less Dividends paid or proposed . ..		2,300		2,875	
		£4,700		£7,625	
Amount attributable to A Ltd.	75%	£3,525	80%	£6,100	£9,625
Balances brought forward – amounts attributable to A Ltd.		4,500		6,400	10,900
		£8,025		£12,500	£20,525

By deducting the retained profit of £9,625 from the group profit for the year the consolidated Profit and Loss Account shows how much of the consolidated profit for the financial year has been dealt with in the accounts of A Ltd., *viz.*, £26,000. After adding the balance brought forward, and deducting the appropriations made by A Ltd., the resultant amount of £36,500 is the Profit and Loss Account balance appearing in A Ltd.'s Balance Sheet. By adding to this amount the *total* profits retained by subsidiaries (including the balances brought forward) the Profit and Loss Account balance appearing in the *consolidated* Balance Sheet is revealed.

§ 7. General Illustration

The following are the draft Profit and Loss Accounts for the year ended 31st March, 1959, and Balance Sheets as at that date, of A Ltd. and its two subsidiaries B Ltd. and C Ltd.

PROFIT AND LOSS ACCOUNTS

	A Ltd.	B Ltd.	C Ltd.		A Ltd.	B Ltd.	C Ltd.
	£	£	£		£	£	£
To Directors' Emoluments	5,500	750	500	By Trading Profit ..	27,340	10,560	6,580
„ Debenture Interest		600		„ Dividends on Quoted Investments	1,440	800	700
„ Depreciation	6,000	1,500	1,500	„ Interest on Debentures, in B Ltd.	400		
„ U.K. Taxation, based on profit for year:				„ Dividend on Ordinary Shares in B Ltd.	2,400		
Profits Tax	4,000	1,200	1,000	Dividend on Shares in C Ltd.:			
Income Tax	8,332	3,290	2,084	Preference . ..	360		
„ Profit for year, after Taxation: c/d.	10,023	4,060	2,213	Ordinary	1,800		
				Interest on Tax Reserve Certificates . .	115		
	£33,855	11,400	7,297		£33,855	11,400	7,297
To Dividends *less* tax:				By Profit for year b/d.	10,023	4,060	2,213
Preference Dividend paid ..			173	„ Balance brought forward, 1st April, 1958	12,000	4,500	5,000
Preference Dividend proposed			172				
Ordinary Dividend proposed	12,938	2,300	1,035				
„ Balance carried forward ..	9,085	6,260	5,833				
	£22,023	8,560	7,213		£22,023	8,560	7,213

2.21
5.00
7.213

%% 6-7

BALANCE SHEETS

	A Ltd. £	A Ltd. £	B Ltd £	B Ltd £	C Ltd £	C Ltd £
SHARE CAPITAL (£1 shares)						
6% Preference						10,000
Ordinary		150,000		20,000		6,000
						16,000
REVENUE RESERVES:						
General Reserve	24,000		8,000		8,000	
Profit and Loss Account	9,085	33,085	6,260	14,260	5,833	13,833
		183,085		34,260		29,833
AMOUNTS SET ASIDE FOR FUTURE INCOME TAX		5,500		2,300		1,500
4% MORTGAGE DEBENTURES				15,000		
CURRENT LIABILITIES						
Trade Creditors	6,076		4,170		3,424	
Profits Tax	4,000		1,200		1,000	
Proposed Dividends (*less* tax).						
Preference (Final)					172	
Ordinary	12,938	23,014	2,300	7,670	1,035	5,631
		£ 211,599		£59,230		£36,964

	A Ltd. £	A Ltd. £	B Ltd. £	B Ltd. £	C Ltd. £	C Ltd. £
FIXED ASSETS:						
Goodwill at cost		15,000				
Freehold Premises at cost		25,000		11,000		
Plant and Machinery at cost	41,000		22,000		14,000	
Less Depreciation	26,000	15,000	10,500	11,500	6,500	7,500
		55,000		22,500		7,500
SUBSIDIARY COMPANIES:						
12,000 Ordinary Shares in B Ltd. at cost, *less* dividend paid out of pre-acquisition profit	32,125					
£10,000 4% Debentures B Ltd.	10,000					
6,000 Preference Shares in C Ltd	8,000					
6,000 Ordinary Shares in C Ltd	16,000	66,125				
CURRENT ASSETS						
Stock in trade	21,295		12,700		6,465	
Debtors	20,000		8,110		7,725	
Quoted Investments	18,000		7,500		10,000	
Tax Reserve Certificates	10,000		4,000		1,875	
Dividends Receivable (*less* tax).						
B Ltd.	1,380					
C Ltd Preference	103					
„ Ordinary	1,035					
Bank Balance	18,661	90,474	4,420	36,730	3,399	
		£ 211,599		£59,230		

Notes

(1) The shares in B Ltd. were acquired on 1st April, 1958, when B Ltd had a credit balance on Profit and Loss Account (after charging the final dividend for the year ended 31st March, 1958) of £4,500, and a General Reserve of £8,000.

(2) The shares in C Ltd. were purchased many years ago when that company had a credit balance on Profit and Loss Account of £2,000 and a General Reserve of £3,000. All subsequent dividends have been paid out of post-acquisition profits.

(3) Inter-company indebtedness (included in Debtors and Creditors) at 31st March, 1959, was: A Ltd to C Ltd £700; B Ltd to A Ltd. £1,240.

(4) A Ltd.'s Stock includes goods purchased from B Ltd for £15,000 of which the cost to B Ltd was £10,000.

(5) The proposed dividends are: A Ltd. 15%; B Ltd. 20%; C Ltd. Ordinary 30%; Final Preference 3%.

Prepare consolidated Profit and Loss Account for the year ended 31st March, 1959 and consolidated Balance Sheet as at that date

The consolidation adjustments are journalised as follows:

		£	£
(*a*) Goodwill	*Dr.*	66,125	
To Ordinary Shares in B Ltd.			32,125
,, Preference Shares in C Ltd.			8,000
,, Ordinary Shares in C Ltd.			16,000
,, Debentures in B Ltd.			10,000
Cost of shares and debentures in subsidiaries.			
(*b*) Ordinary Share Capital, B Ltd.	*Dr.*	12,000	
Preference Share Capital, C Ltd.		6,000	
Ordinary Share Capital, C Ltd.		6,000	
Debentures, B Ltd.		10,000	
To Goodwill			34,000
Nominal value of shares and debentures in subsidiaries.			
(*c*) General Reserve, B Ltd. – 3/5 ths × £8,000	*Dr.*	4,800	
Profit and Loss Account, B Ltd. – 3/5 ths × £4,500		2,700	
To Goodwill			7,500
Pre-acquisition profits of B Ltd. applicable to A Ltd.'s holding.			
(*d*) General Reserve, C Ltd.	*Dr.*	3,000	
Profit and Loss Account, C Ltd.		2,000	
To Goodwill			5,000
Pre-acquisition profits of C Ltd. applicable to A Ltd.'s holding.			
(*e*) Creditors A Ltd.	*Dr.*	700	
,, B Ltd.		1,240	
To Debtors C Ltd.			700
,, ,, A Ltd.			1,240
Cancelling inter-company balances.			
(*f*) Trading Profit	*Dr.*	3,000	
To Stock			3,000
Provision for unrealised inter-company profits on Stock held by A Ltd. (3/5 ths of £5,000).			
(*g*) Interest on Debentures, A Ltd.	*Dr.*	400	
To Debentures Interest, B Ltd.			
Cancelling interest on debentures in B Ltd. held by A Ltd.			
(*h*) Dividend on Ordinary Shares, B Ltd.	*Dr.*	2,400	
,, ,, Preference Shares, C Ltd.		360	
,, ,, Ordinary Shares, C Ltd.		1,800	
To Preference Dividend, C Ltd. (3/5 ths × £345)			207
,, Ordinary Dividend, B Ltd. (3/5 ths × £2,300)			1,380
,, Ordinary Dividend, C Ltd			1,035
,, Taxation Account, A Ltd. (8s. 6d. in £ on £4,560)			1,938
Cancelling inter-company dividends			
(*i*) Share Capital, B Ltd.	*Dr.*	8,000	
General Reserve, B Ltd. (2/5 × £8,000)		3,200	
Profit and Loss Account, B Ltd:			
Balance brought forward (2/5 × £4,500)		1,800	
Profit for year (2/5 × £4,060)		1,624	
To Minority Interest, B Ltd.			14,624
Share Capital, reserves and profits applicable to outside shareholders of B Ltd.			
(*j*) Preference Share Capital, C Ltd.	*Dr.*	4,000	
Preference Dividend, C Ltd (6% on £4,000, less tax)		138	
To Minority Interest, C Ltd.			4,138
Share Capital and profits applicable to outside shareholders of C Ltd.			

The Goodwill Account will appear as follows:

GOODWILL

	£		£
To Ordinary Shares in B Ltd. (*a*)	32,125	By Share Capital, B Ltd. (*b*)	12,000
,, Debentures in B Ltd. (*a*)	10,000	,, Debentures, B Ltd. (*b*)	10,000
		,, Pre-acquisition profits (*c*)	7,500
		,, Balance = Goodwill in B Ltd.	12,625
	£42,125		£42,125
To Preference Shares in C Ltd. (*a*)	8,000	By Preference Shares. Capital C Ltd. (*b*)	6,000
Ordinary Shares in C Ltd. (*a*)	16,000	,, Ordinary Shares. Capital C Ltd. (*b*)	6,000
		,, Pre-acquisition profits (*d*)	5,000
		,, Balance = Goodwill in C Ltd.	7,000
	£24,000		£24,000

Goodwill = £(12,625 + 7,000) = £19,625.

A LTD. AND SUBSIDIARIES
CONSOLIDATED PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST MARCH, 1959

			£
Trading Profit for year			25,530
After charging:			
Directors' Emoluments	£6,750		
Debenture Interest	200		
Depreciation	9,000		
	£15,950		
Dividends on Quoted Investments		2,940	
Interest on Tax Reserve Certificates		172	
			3,112
PROFIT FOR YEAR, BEFORE TAXATION			28,642
Deduct United Kingdom Taxation, based on income for year.			
Profits Tax .		6,200	
Income Tax		11,768	
			17,968
PROFIT FOR YEAR, AFTER TAXATION			10,674
Deduct Profit for year applicable to Minority Interests			1,762
			8,912
Deduct Profit for year retained by subsidiaries, attributable to group			1,889
Group profit for year dealt with in Accounts of A Ltd			7,023*
Add Balance brought forward			12,000
			19,023
Deduct Ordinary Dividend proposed, 15 per cent less tax			12,938
BALANCE CARRIED FORWARD BY A LTD . .			6,085*
Add Total retained profits of subsidiaries applicable to group			4,889
BALANCE CARRIED FORWARD IN CONSOLIDATED BALANCE SHEET			£10,974

* The difference of £3,000 between this amount and the profit for the year as shown in A Ltd.'s draft Profit and Loss Account is caused by the provision made in the group accounts for unrealised inter-company profit. In such circumstances it is usual for the holding company to make entries giving effect to such provisions in its own books.

A LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
AS AT 31ST MARCH, 1959

		£			£
SHARE CAPITAL, Authorised, Issued and Fully Paid – 150,000 Shares of £1 each		150,000	FIXED ASSETS: Goodwill, A Ltd.		15,000
REVENUE RESERVES: .		39,974	*Add* Excess of Cost of Shares and Debentures in Subsidiaries over net assets attributable thereto		19,625
		189,974			34,625
AMOUNT SET ASIDE FOR FUTURE INCOME TAX		9,300	Freehold Premises, at cost		36,000
			Plant and Machinery, at cost .	77,000	
4% MORTGAGE DEBENTURES, B Ltd. .		5,000	*Less* Provision for Depreciation . .	43,000	
					34,000
CURRENT LIABILITIES:					104,625
Trade Cerditors	11,730		CURRENT ASSETS:		
Profits Tax . . .	6,200		Stock in Trade	37,460	
Proposed Dividends (*less* tax)	12,938	30,868	Debtors	33,895	
MINORITY INTEREST .		18,693	Quoted Investments .	35,500	
			Tax Reserve Certificates .	15,875	
			Bank Balances	26,480	
		£253,835			

Notes. The figures appearing in the Consolidated Profit and Loss Account and Consolidated Balance Sheet are the combined figures appearing in the separate accounts, after effect has been given as under to the consolidating adjustments journalised on page 388. Details are set out on pages 390-1. The italicised letters in brackets refer to the journal entries.

PROFIT AND LOSS ACCOUNT

			£
(1) Trading profit for year credit per accounts ..			44,480
Less Provision for unrealised profits (*l*) ..			3,000
			41,480
Less Expenses disclosed in account .			15,950
(2) Debenture Interest B Ltd. – charge per accounts			600
Less paid to A Ltd. (*g*) .			400
			£200
(3) Income Tax charge per accounts ..			13,706
Less applicable to inter-company dividends (*h*)			1,938
			£11,768
(4) Profit for year applicable to Minority Interests:			
B Ltd. (*i*)			1,624
C Ltd. (*i*) .			138
			£1,7
(5) Profit for year retained by subsidiaries, applicable to group			
B Ltd. profit for year per accounts		4,060	
Less dividends		2,300	
12/20ths of			
C Ltd. – profit for year per accounts .		2,213	
Less dividends		1,380	
			833
			£1,889
(6) Total retained profits applicable to group:			
B Ltd. Balance carried forward per accounts		6,260	
Less Pre-acquisition profit .		4,500	
12/20ths of .		£1,760	
C Ltd – Balance carried forward per accounts		5,833	
Less Pre-acquisition profits		2,000	
			3,833
			£4,889

BALANCE SHEET

(7) Goodwill as per account (p. 388) .			19,625
(8) Revenue Reserves			
General Reserve A Ltd per accounts			24,000
" " B Ltd per accounts ..		8,000	
Less Pre-acquisition profits .	£4,800 (*c*)		
Minority interest ..	3,200 (*i*)		
		8,000	
General Reserve C Ltd. .		8,000	
Less pre-acquisition profits (*d*) .		3,000	
			5,000
Consolidated Profit and Loss Account			10,974
			£39,974
(9) Debentures in B Ltd.			15,000
Less held by A Ltd			10,000
			£5,000
(10) Creditors per accounts			13,670
Less Inter-company indebtedness (*e*)			1,940
			£11,730

BALANCE SHEET (*continued*)

Minority Interests:		
B Ltd. – Share Capital	8,000	
General Reserve	3,200	
Profit and Loss Account 8/20ths × £6,260	2,504	
Proposed Dividend 8/20ths × £2,300	920	
		14,624
C Ltd. – Preference Capital	4,000	
Proposed Dividend – 4/10ths × £172	69	
		4,069
		£18,693

(12) Stock – per accounts	40,460
Less Provision for unrealised profit (*f*)	3,000
	£37,460

(13) Debtors – per accounts .	35,835
Less Inter-company indebtedness (*e*)	1,940
	£33,895

DEPARTMENTAL ACCOUNTS; BRANCH ACCOUNTS

§ 1. Departmental Accounts

In a business where there are two or more departments, it is very important that the accounting system shall be so devised as to enable the trading results of each department to be accurately ascertained as regards turnover and expenses, as well as profits.

In order to obtain the desired particulars, separate records must be kept of the purchases and sales of each department. Stock of each department must be taken separately, and the expenses that can be allocated directly to any department must be charged thereto, other expenses being apportioned on some reasonable basis; for example, either in proportion to the turnover of each department, or (as in the case of rent) to the amount of floor space occupied, or in any other way which may be expedient in the circumstances. In order to allocate the purchases and sales correctly, either separate day books must be kept for each department, or columnar day books with a column for each department; otherwise the day books must be analysed. The first method is not always convenient, as it frequently involves a large number of duplicate entries, especially as regards purchases.

Where the number of departments is small, it is convenient to use columnar forms of bought and sold day books, return books, etc., having a total column from which the posting is made to the personal accounts, and detail columns, the totals of which at the end of each month or other period are posted to their respective accounts in the impersonal ledger.

It is important to note that stock must be taken for each department separately, and proper records kept of all transfers from one department to another.

Where a mechanised accounting system has been installed the necessary analysis would be effected by the machines, as explained in Chapter XI.

Illustration

The following is the trial balance of the Excelsior Trading Company Limited, on 31st December.

	£	£
Ordinary Share Capital		10,000
Preference ,, ,,		5,000
4% First Mortgage Debentures		5,000
Stock 1st January, Dept. A	8,000	
,, ,, ,, ,, B	3,000	
Purchases, Dept. A	23,000	
,, ,, B	15,000	
Wages, Dept. A	1,000	
,, ,, B	500	
Carriage and Freight	1,500	
Salaries	750	
Travelling Expenses	900	
Incidental ,,	150	
Rates and Taxes	300	
Fuel, Light and Water	120	
Insurance	60	
Carried forward	£54,280	£20,000

	£	£
Brought forward	54,280	20,000
Sales Dept A . .		30,000
„ „ B . . .		20,000
Sundry Debtors . .	9,000	
Bills Receivable . . .	1,500	
Sundry Creditors .		4,000
Freehold Premises at cost . . .	4,200	
Managing Director's Salary . .	1,000	
Directors' Fees . .	500	
Stationery and Stamps .	170	
Discounts . . .	600	
Preference Dividend half-year to 30th June	150	
Debenture Interest half-year to 30th June	100	
Cash in Hand	100	
Balance at Bank	3,000	
Profit and Loss Account Balance at 1st January		600
	£74,600	£74,600

Provide £500 for bad debts, and make out departmental Trading and Profit and Loss Accounts (dividing the expenses between the departments in proportion to the sales), and Balance Sheet at 31st December. The stock at 31st December was - Department A, £6,000; Department B, £2,800. The nominal capital of the company is £25,000, divided into 15,000 ordinary shares of £1 each, and 10,000 6 per cent. cumulative preference shares of £1 each, and the shares issued are fully paid. Ignore income tax.

THE EXCELSIOR TRADING COMPANY, LIMITED

DEPARTMENTAL TRADING AND PROFIT AND LOSS ACCOUNTS FOR THE YEAR ENDED 31ST DECEMBER

	Dept. A	Dept. B	TOTAL		Dept. A	Dept. B	TOTAL
	£	£	£		£	£	£
To Stock . .	8,000	3,000	11,000	By Sales	30,000	20,000	50,000
„ Purchases . .	23,000	15,000	38,000	„ Stock	6,000	2,800	8,800
„ Wages . .	1,000	500	1,500				
„ Balance being Gross Profit c/d . .	4,000	4,300	8,300				
	£36,000	£22,800	£58,800		£36,000	£22,800	£58,800
To Managing Director's Salary	600	400	1,000	By Gross Profit b/d	4,000	4,300	8,300
„ Directors' Fees . .	300	200	500	„ Balance, being Net Lo[ss]	50		
„ Carriage and Freight .	900	600	1,500				
„ Salaries . . .	450	300	750				
„ Travelling Expenses . .	540	360	900				
„ Incidental Expenses .	90	60	150				
„ Rates and Taxes .	180	120	300				
„ Fuel, Light and Water	72	48	120				
„ Insurance .	36	24	60				
„ Stationery and Stamps .	102	68	170				
„ Discounts	360	240	600				
„ Bad Debts Provision .	300	200	500				
„ Debenture Interest . .	120	80	200				
„ Balance, being Net Profit carried forward . .	—	1,600	1,550				
	£4,050	£4,300	£8,300		£4,050	£4,300	£8,300

THE EXCELSIOR TRADING COMPANY, LIMITED

BALANCE SHEET AS AT 31ST DECEMBER

		£				£
Share Capital:			Fixed Assets.			
Authorised—			Freehold Premises at cost			4,200
15,000 Ordinary Shares of £1 each . .		15,000				
10,000 6% Cumulative Preference Shares of £1 each . . .		10,000	Current Assets:			
		£25,000	Stock		8,800	
			Sundry Debtors . . .	£9,000		
			Less Provision for Bad Debts	500		
					8,500	
Issued and Fully Paid Capital:			Bills Receivable . .		1,500	
10,000 Ordinary Shares of £1 each		10,000	Balance at Bank .	£3,000		
5,000 Preference Shares of £1 each		5,000	Cash in Hand . . .	100		
					3,100	
		15,000				21,900
Carried forward		£15,000	Carried forward . .			£26,100

THE EXCELSIOR TRADING COMPANY, LIMITED

BALANCE SHEET AS AT 31ST DECEMBER (*continued*)

		£			£	£
Brought forward		15,000		Brought forward		26,100
Profit and Loss Account:						
Balance at 1st January	£600					
Add Profit for year	1,550					
	2,150					
Less Preference Share Dividends	300					
		1,850				
			16,850			
4% 1st Mortgage Debentures			5,000			
Current Liabilities:						
Sundry Creditors .		4,000				
Debenture Interest..		100				
Provision for Final Dividend on Preference Shares		150				
			4,250			
			£26,100			

§ 2. Branch Accounts

The system of accounts to be employed by a concern having branch establishments must depend to a large extent upon the nature of the trade carried on and the form of organisation of the business, the principal aim being to impose an effective control over the branches and to ensure that all goods and cash passing through their hands are fully accounted for.

Broadly speaking, branches may be divided into three classes, *viz.*:

(1) Branches for which the whole of the accounting records are kept at the head office.

(2) Branches which maintain separate accounting records.

(3) Foreign Branches.

It is proposed to describe here each of these systems in detail.

§ 3. Branches for which the whole of the accounting records are kept at head office

This system is recommended for use where the branches are, in effect, merely sales departments, receiving all the goods they deal in from the head office, to whom the branch managers must account therefor. The system is particularly suitable for retail branches, the whole or the bulk of whose sales are for cash. Where credit sales are permitted a personal ledger may be kept at the branch for credit customers, the head office maintaining a Total (or Control) Account for branch debtors which is written up in total from the branch manager's returns. Wherever practicable, the whole of the cash takings and cash received by the branch from debtors should be remitted intact daily to the head office by being paid into a local branch of the bank for the credit of head office account. The expenses of the branch should be paid, as far as possible, by cheque from the head office, in whose books they will be debited to appropriate branch Expenses Accounts. Incidental expenses which have to be paid locally, in cash, may be dealt with through an imprest provided by head office, and replenished at regular intervals by a cheque for the actual amount of such expenditure, as shown by the branch manager's returns.

Where credit sales at the branch are considerable, it is sometimes expedient for the Debtors' Accounts to be kept in the head office books, and for statements to be rendered by, and remittances made direct to, the head office. In such a case, each sale will be recorded at the branch in triplicate, one copy going to the customer as an invoice, the second being sent to the head office to be used as the posting medium, and the third being retained by the branch for reference.

With regard to stock, where the nature of the goods renders it possible, quantity stock accounts should be maintained at the head office of all goods sent to, and sales made by the branch. These accounts will operate as a perpetual inventory by means of which the quantity of each of the various lines of goods in hand at the branch can be checked and discrepancies enquired into. Where, owing to the nature of the goods, it is not possible to maintain quantity stock accounts, goods should, if practicable, be charged out to the branch either at actual selling price, or at cost price plus a fixed percentage. This will enable a check to be imposed on the branch dealings, as will be shown hereunder.

(a) Where Goods are charged to Branches at selling prices

The principal aim in formulating a system of accounts for a concern having a number of branches, such as retail shops, all of which sell the same lines of goods at fixed selling prices, is to provide an adequate check on the branch managers and staffs, so as to ensure that all goods and cash passing through their hands are fully accounted for. This can most effectively be done, where the nature of the business permits it, by charging out all goods at the actual prices at which they are to be sold by the branches. In cases where the selling prices of all goods are ascertained by adding the same percentage to cost price, the system described in § 3 (*c*) of this chapter should be employed. Where, however, it is not possible to adopt a fixed gross profit percentage for all goods (*e.g.*, where they consist of proprietory lines, the selling prices of which are fixed by the manufacturers; or where the market conditions in relation to certain lines of goods render it necessary to offer them at more competitive prices than others) a system analogous to that now to be described should be adopted.

All goods should be purchased through a central buying department at the head office, from which they should be issued to the branches on requisitions from the managers, or in accordance with directions given by the sales manager. In cases where it is expedient to empower a branch manager to requisition supplies of goods direct from manufacturers or wholesalers copies of the orders given should be sent by the manager to the head office, and the goods should be invoiced by the suppliers to the head office, by whom they should then be charged out to the branch.

All goods charged by head office to a branch should be invoiced at the selling prices fixed by head office.

In the head office books the following accounts should be kept in respect of each branch:

(1) Branch Stock Account; (2) Goods sent to Branch Account;
(3) Expense Accounts; (4) Total Debtors Account;

the last account being required only where the branch is permitted to sell goods on credit.

Analysis books or loose leaf records must be maintained in which the day-to-day transactions of the branches will be entered and from which the periodical totals to be posted to the ledger accounts relating to each branch will be obtained.

Branch Stock Account will be debited and Goods sent to Branch Account credited with the total selling price of all goods sent to the branch. Goods returned by the branch to head office will be credited to Branch Stock Account and debited to Goods sent to Branch Account. Any transfers of goods from one branch to another should be credited to the Branch Stock Account of the transferee branch and debited to the Branch Stock Account of the transferor branch. (Alternatively they may be recorded as having been returned to head office by the transferor branch and reissued by head office to the transferee branch.)

Preferably, all cash received by the branch, both in respect of cash sales and from debtors, should be paid intact into a local branch of the bank for the credit of head office, the branch expenses being discharged by head office, either by cheque direct, or through a branch cash float provided by head office and maintained on the imprest system.

The branch manager should be required to forward to head office at weekly or other intervals returns giving particulars of goods received from and returned to head office, cash and credit sales, cash received from debtors, expenses, cash banked, etc. and showing the figures of stock, debtors and cash in hand at the end of the period. From these particulars the necessary entries can be made in the statistical records relating to the branch, from which postings to the ledger accounts can be made periodically.

A form of a branch manager's weekly return suitable for use by a concern operating a chain of retail shops is given on page 397.

The total amount received by the branch in respect of cash sales, and the total of the credit sales at the branch will be credited to the Branch Stock Account, Cash and Total Debtors Accounts respectively being debited. The Total Debtors Account will be credited with cash received from and discounts allowed to debtors during the period and with bad debts written off, so that the balance of this account will represent the amount of the book debts at the end of the period. Branch expenses will be debited to the appropriate nominal accounts.

Having been debited with the total of the goods sent to the branch and credited with sales and goods returned to head office, all at selling prices, the Branch Stock Account should disclose a balance representing the closing stock of the branch at selling prices, and this should be credited to the account and carried forward to the debit of the account for the next period. The stock figure must be reconciled with the actual stock taken, any difference being traced to its origin and the requisite adjustment made or, if immaterial in amount, written off to Goods sent to Branch Account.

BRANCH RETURN FOR WEEK ENDED 19 BRANCH REF.

	Allowances to Customers	Cash Received: Credit Sales	Cash Received: Cash Sales	Cash Received: Total	Cash Payments: Expenses	Cash Payments: Bankings	Goods Received: Advice Numbers	Goods Received: Amount
	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.		£ s. d.
MONDAY ..								
TUESDAY ..								
WEDNESDAY								
THURSDAY ..								
FRIDAY ..								
SATURDAY ..								

SALES CONTROL:

	£ s. d.
Debtors at end ..	
Allowances to Customers	
Cash from Credit Sales	
Less Debtors at start..	
Credit Sales for Week .	
Cash Sales	
TOTAL SALES	

	£ s. d
Stock at start	
Less Total Sales	
Returns	
Stock at end .	

Cash Float at start At end

On reverse of this Return:
(i) List the names and addresses of customers and amount of each debt where more than 4 weeks in arrear.
(ii) Give details of all allowances to customers in excess of £1.
Attach vouchers for all cash expenses.

Remarks:

Signature of Manager.

Where the above system is adopted, it will not be possible to ascertain from the books, without special calculation, the exact profit or loss of the branch, owing to the fact that the goods are charged out at selling prices which do not include a fixed percentage of profit, but this disadvantage is more than counterbalanced by the very material benefit obtained from being able to prove the correctness of the stock, and consequently also of the cash. Moreover, in businesses of this nature the rate of gross profit earned by each branch may usually be taken to be the same as that earned by the business as a whole, as revealed by the Trading Account, and consequently, so long as the turnover of the branch is known, a reliable estimate of the result of trading can easily be made.

The issue of goods by the head office to the branch does not constitute a sale, but is merely a change of location of stock within the business. The goods are accordingly credited, in the first instance, not to Sales Account, but to a Goods sent to Branch Account. If the whole of the goods were sold by the branch at the prices at which they were invoiced, the amount credited to this account could, at the end of the accounting period, be transferred to the credit of Sales Account. If, however, as will usually be the case, some of the goods remain unsold, the selling price of such unsold stock must be deleted from the Goods sent to Branch Account, by being debited thereto and carried down to the credit of the account to form an opening balance in the new period. The balance of the Goods sent to Branch Account will then represent the sales actually effected by the branch, and may be transferred to Sales Account. The amount of the unsold stock carried forward to the credit of that account is in the nature of a reserve for the amount of stock brought down as a debit in the Branch Stock Account. When preparing the final accounts, therefore, the balances carried forward on the Branch Stock Account and the Goods sent to Branch Account will cancel each other out, and can thus be eliminated from the accounts. (In effect, these entries are the same as if the unsold stock had been returned to the head office on the last day of the accounting period, and reissued by the head office to the branch on the first day of the new period.) The branch stock may then be valued at cost, or under, and included in the stock figure which is credited to Trading Account and debited to General Stock Account.

Illustration (1)

Messrs. J. Foster & Co. have a head office which acts as a distributing centre to their two branches, where all sales are made. All purchases are made by the head office, and goods are charged out to the branches at selling price. All expenses (except petty expenses which are provided for by imprest from head office) are paid by the head office, where the books are kept, except the sales ledgers, which are kept at the branches. The head office, however, keeps Total Debtors Accounts in respect of these. On taking stock at Branch A at selling price, it was found that the actual stock was short by £12 compared with the balance of the Stock Account. In the same way the actual stock at Branch B was greater by £7 than the balance on their Stock Account. It was decided to write off these differences.

From the particulars given, write up the Branch Accounts in the head office books, and prepare Trading and Profit and Loss Accounts for the year ended 31st December, and Balance Sheet as at that date.

	Head Office	Branch A	Branch B
	£	£	£
Stock at 1st January at Selling Price		2,000	1,400
Goods sent to Branches		15,000	10,000
Net Credit Sales		9,820	6,390
Cash Sales		5,150	3,321
Goods Returned to Head Office		200	120
Allowances off Selling Price		118	76
Debtors at 1st January		750	540
Cash received from Debtors		9,615	6,192
Discounts allowed to Debtors		160	107
Bad Debts		105	41
Stock at 1st January, at Cost, at Head Office and Branches	7,600		
Ditto 31st December	6,900		
Purchases	13,621		
Salaries	1,020	620	490
Trade Expenses	420	115	76
Rent, Rates and Taxes	349	325	190
Depreciation	650		
Discounts Received	264		
Creditors	2,432		
J. Foster, Capital Account	14,942		
" Drawing Account	5,140		
Leasehold Premises	5,200		
Fixtures and Fittings	3,120		
Cash at Bank	1,640		
Petty Cash	22	18	10

STOCK ACCOUNT, BRANCH A

			£			£
Jan. 1	To Balance – Stock b/f.		2,000	Dec. 31	By Net Credit Sales	9,820
Dec. 31	" Goods from Head Office		15,000		" Cash Sales	5,150
					" Returns to Head Office	200
					" Allowances off Selling Price	118
					" Difference in Stock	12
					" Balance – Stock c/d	1,700
			17,000			£17,000
Jan. 1	To Balance – Stock b/d.		1,700			

STOCK ACCOUNT, BRANCH B

		£			£
Jan. 1	To Balance – Stock b/f.	1,400	Dec. 31	By Net Credit Sales	6,390
Dec. 31	" Goods from Head Office	10,000		" Cash Sales	3,321
	" Difference in Stock	7		" Returns to Head Office	120
				" Allowances off Selling Price	76
				" Balance – Stock c/d.	1,500
		£11,407			£11,407
Jan. 1	To Balance – Stock b/d.	1,500			

TOTAL DEBTORS ACCOUNT, BRANCH A

		£			£
Jan. 1	To Balance b/f.	750	Dec. 31	By Cash	9,615
Dec. 31	" Net Credit Sales	9,820		" Discounts	160
				" Bad Debts	105
				" Balance c/d.	690
		£10,570			£10,570
Jan. 1	To Balance b/d	690			

TOTAL DEBTORS ACCOUNT, BRANCH B

		£			£
Jan. 1	To Balance b/f.	540	Dec. 31	By Cash	6,192
Dec. 31	" Net Credit Sales	6,390		" Discounts	107
				" Bad Debts	41
				" Balance c/d.	590
		£6,930			£6,930
Jan. 1	To Balance b/d.	590			

GOODS SENT TO BRANCH A ACCOUNT

		£			£
Dec. 31	To Returns from Branch ..	200	Jan. 1	By Balance - Stock Suspense b/f.	2,000
	„ Allowances off Selling Price	118	Dec. 31	„ Goods to Branch	15,000
	„ Difference in Stock ..	12			
	„ Transfer to Sales Account	14,970			
	„ Balance – Stock Suspense c/d.	1,700			
		£17,000			
			Jan. 1	By Balance – Stock Suspense b/d.	

GOODS SENT TO BRANCH B ACCOUNT

		£			£
Dec. 31	To Returns from Branch ..	120	Jan. 1	By Balance – Stock Suspense b/f.	1,400
	„ Allowances off Selling Price	76			
	„ Transfer to Sales Account	9,711	Dec. 31	„ Goods to Branch .. .	10,000
	„ Balance – Stock Suspense c/d.	1,500		„ Difference in Stock .	
		£11,407			
			Jan. 1	By Balance – Stock Suspense b/d.	

TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER

	£	£		£	£
			By Sales:		
To Stock ..		7,600	Branch A	14,970	
„ Purchases		13,621	Branch B	9,711	
„ Gross Profit c/d.		10,360			24,681
			„ Stock ..		6,900
		£31,581			£31,581
To Salaries:					
Head Office	1,020		By Gross Profit b/d. .		10,360
Branch A	620		„ Discounts Received		264
Branch B . ..	490				
		2,130			
„ Trade Expenses.					
Head Office	420				
Branch A .	115				
Branch B . . .	76				
		611			
„ Rent, Rates and Taxes:					
Head Office .	349				
Branch A	325				
Branch B	190				
		864			
„ Discounts Allowed:					
Branch A	160				
Branch B . .	107				
		267			
„ Bad Debts:					
Branch A . . .	105				
Branch B .. .	41				
		146			
„ Depreciation		650			
„ Balance, being Net Profit carried to Capital Account		5,956			
		£10,624			£10,624

BALANCE SHEET AS AT 31ST DECEMBER

					£	£
J. Foster, Capital Account:			Leasehold Premises .			5,200
Balance at 1st January	14,942		Fixtures and Fittings ..			3,120
Add Profit ..	5,956		Stock ..			6,900
			Sundry Debtors:			
	20,898		Branch A		690	
Less Drawings	5,140		Branch B .. .		590	
		15,758				1,280
Sundry Creditors		2,432	Cash:			
			At Bank .. .		1,640	
			In Hand:			
			Head Office	£22		
			Branch A	18		
			Branch B	10		
					50	
						1,690
		£18,190				£18,190

If desired, the gross profit of each branch can be ascertained by apportioning the gross profit disclosed by the Trading Account between and branches on the basis of their respective turnovers. Thus, in the above illustration, the gross profit of £10,360 would be apportioned as to $\frac{14,970}{24,681} =$ £6,284 to Branch A, and $\frac{9,711}{24,681} =$ £4,076 to Branch B. The net profit of each branch could then be found by deducting the expenses relating to that branch from its gross profit.

In the above illustration, the shortages in the branch stocks are unimportant, and can probably be attributed to normal causes, such as evaporation, loss in weight, breaking bulk, clerical errors, etc. In such circumstances the differences would be written off by crediting the Branch Stock Account and debiting the Goods sent to Branch Account, thereby reducing the branch sales. Where, however, the difference is large, and irregularities are suspected, their origin must be investigated and appropriate adjustments made. If, for example, a shortage is found to be due to the misappropriation of cash takings, the full amount of the difference should be credited to the Branch Stock Account and debited to Profit and Loss Account. The goods having been sold, the gross profit thereon has been earned, and the amount of the gross profit disclosed by the Trading Account should not, therefore, be reduced. The misappropriation of cash, however, represents a loss *after* the earning of the gross profit, and must be debited to Profit and Loss Account.

If the difference on the Branch Account is found to be due to the pilferage or destruction of stock, the correct adjustment is to eliminate the selling price of the goods from the accounts by crediting the Branch Stock Account and debiting the Goods sent to Branch Account therewith, as if the goods had been returned by the branch to the head office. The *cost* price of the goods must then be credited to Trading Account (or Purchases Account) and debited to Profit and Loss Account. In this case, since the goods were never sold the gross profit has not been earned, and the true measure of the loss to the business is the *cost* of the goods, which must accordingly be taken out of the Trading Account and debited to Profit and Loss Account.

In some cases it may be inexpedient for the branch expenses to be paid by the head office, and the branch manager may be permitted to pay expenses incurred locally out of his cash takings, and to make periodical remittances to the head office of the balance of cash remaining in his hands, or of round sums, instead of paying the whole of his takings into the bank for the credit of head office. Where this is done, instead of being credited with the total sales, the Branch Account will be credited with the remittances made to the head office and the expenses paid by the branch. The balance of the Branch Account will then represent the unsold stock at the branch, valued at selling price, plus any balance of cash takings not yet remitted to the head office. Where credit sales are small, and it is not considered necessary to maintain a Total Debtors Account for the branch in the head office books, the balance of the Branch Account may also include the total of any outstanding debts owing by branch customers at the date of balancing the accounts.

Illustration (2)

Piddington & Co. carry on a retail business in London, and have a suburban branch to which all goods are supplied by head office and invoiced at selling prices. The branch manager pays all the branch expenses out of takings and makes remittances periodically to the head office. No accounts are kept in the head office books of branch debtors and cash.

From the following information, show the accounts in the head office books recording the branch transactions, and prepare a Trading and Profit and Loss Account of the business for the year ended 31st December.

Extracts from branch returns to head office:

		£
Goods invoiced from head office		6,696
Remittances to head office		5,250
Expenses paid:		
Rent		400
Rates and Insurance		120
Wages		650
Lighting and Heating		50
General Expenses		72
Cash in hand (31st December)		64
Debtors " "		130
Stock " "		750 (cost £508)

Extracts from head office books:

		£
Rent		1,000
Rates and Insurance		320
Salaries and Wages		5,400
Heating and Lighting		120
General Expenses		742
Carriage Outwards		563
Travelling Expenses		748
Discounts		450
Stock at cost (1st January)		3,247
Purchases		36,214
Sales		45,402
Branch Account (1st January):		
Cash	£93	
Debtors	157	
Stock	540	
		790

Head office stock at 31st December was valued at £3,625.

The following provisions are to be made:

Depreciation: Head office £100 Branch £20

Bad debts " " £250 " £10

The branch is to be charged with £400 for management expenses.

BRANCH ACCOUNT

		£	£			£	£
	To Balance b/f.:			Dec. 31	By Cash from Branch ..		5,250
	Cash .. .	93			,, Expenses:		
	Debtors.. .	157			Rent .. .	400	
	Stock	540			Rates and Insurance	120	
			790		Wages .	650	
Dec. 31	,, Goods from Head Office		6,696		Lighting and Heating	50	
					General Expenses	72	
							1,292
					,, Balance b/d.:		
					Cash .	64	
					Debtors	130	
					Stock	750	
							944
			£7,486				£7,486
	To Balance b/d.:						
	Cash ..	64					
	Debtors	130					
	Stock .	750					

GOODS SENT TO BRANCH ACCOUNT

		£			£
Dec. 31	To Trading Account:		Jan. 1	By Stock b/d.	540
	Sales	6,486	Dec 31	Branch Account.	
	,, Balance c/d.:			Goods to Branch	6 696
	Stock	750			
		£7,236			£7,236
			Jan 1	By Stock b/d.	750

TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER

	£	£		£	£
To Stock, 1st January .. .		3,247	By Sales Head Office	45,402	
,, Purchases		36,214	Branch .	6,486 ✓	
Gross Profit (apportioned on basis of Sales):					51,888
Head Office . .	£14,490		,, Stock, 31st December:		
Branch	2,070		Head Office	3,625	
			Branch .	508	
					4,133
					£56,021

	Head Office £	Branch £	Total £		Head Office £	Branch £	Total £
To Rent	1,000	400	1,400	By Gross Profit b/d.	14,490	2,070	16,560
,, Rates and Insurance	320	120	440	,, Management Expenses charged to Branch	400		
,, Salaries and Wages	5,400	650	6,050				
,, Heating and Lighting	120	50	170				
,, General Expenses ..	742	72	814				
,, Carriage Outwards	563		563				
,, Travelling Expenses	748		748				
,, Discounts ..	450		450				
,, Provision for Bad Debts	250	10	260				
,, Depreciation ..	100	20	120				
,, Management Expenses		400					
,, Net Profit .	5,197	348	5,545				
	£14,890	£2,070	£16,560		£14,890	£2,070	£16,560

Note

The branch cash and debtors brought down in the Branch Account appear in the Balance Sheet under their appropriate headings. The branch stock, however, is brought down in the the Branch Account at selling price. This is cancelled out against the credit balance of a similar amount carried down in the Goods sent to Branch Account. The *cost* of the branch stock, *viz*., £508, is then credited to Trading Account and debited to General Stock Account as part of which it appears in the Balance Sheet.

Where goods are transferred from one branch to another, the simplest method of recording the transaction is to treat the goods as having been returned to the head office by the transferor branch and issued from the head office to the transferee branch. If, however, only one 'Goods sent to Branches Account' is kept for all branches, a transfer can be journalised, crediting the transferor branch and debiting the transferee branch, at selling price, unless another agreed price has to be adopted, in which case any difference between such price and the price at which the goods were invoiced to the transferor branch by head office must be transferred to the Goods sent to Branches Account.

(b) When Goods are charged to Branches at cost price

In some businesses it is impracticable to work on the method just described, either because the stock is of a perishable nature, or by reason of the fact that selling prices are subject to considerable fluctuation. In such cases the goods will normally be charged out at cost. As a result, it will not be possible, in the head office books, to keep a Branch Stock Account which can be reconciled by including the closing stock, but, on the other hand, all the necessary material will be provided for the preparation of a proper Trading Account for the branch, the opening and closing stocks being taken at cost price, and the goods sent to the branch being charged out at cost price. The cash and credit sales will be ascertained in a similar manner to that described under the first described system, as also will all the other items.

Although, when goods are charged out at cost, the exact result of the trading can be ascertained, it is apparent that the check imposed by the selling price system is not available, and consequently it may be advantageous to maintain stock records for each branch compiled monthly in the following manner:

The opening stock will be taken, and to it will be added the purchases. From the total thus obtained, the sales will be deducted. The gross profit, estimated at the average rate, will then be added, and the result will represent the estimated cost price of the stock on hand. By a comparison of these monthly figures it can be seen whether the stock fluctuates, and if there is reason to suspect any irregularity the actual stock can be taken without previous notice to the manager. It must be remembered, however, that this arrangement forms no part of the double entry book-keeping, and is merely in the nature of a periodical test check.

Illustration (1)

BRANCH A. MONTHLY STOCK ACCOUNTS – JANUARY TO JUNE

	Jan.	Feb.	Mar.	April	May	June
	£	£	£			
Opening Stock	1,400	1,225	1,175			
Add Purchases	200	250	350			
	1,600	1,475	1,525			
Less Sales	500	400	420			
	1,100	1,075	1,105			
Add Gross Profit 25% on Sales	125	100	105			
Estimated Closing Stock ..	£1,225	£1,175	£1,210			

Illustration (2)

Goods are charged out from the head office of a company to its branches at cost price. Cash received at the branches is remitted to head office daily. All expenses are paid by the head office. From the following particulars, prepare Profit and Loss Account of the X Branch for the year ended 31st December.

	£
Goods sent to branch, *less* Returns	4,070
Stock, 1st January	690
Cash received from branch .	6,200
Stock, 31st December	740
Debtors, 1st January	75
Debtors, 31st December ..	89
Rent, rates and taxes ..	160
Wages and sundry expenses ..	340

BRANCH TRADING AND PROFIT AND LOSS ACCOUNT
FOR YEAR ENDED 31ST DECEMBER

	£		£
To Stock, 1st January	690	By Sale	6,214
,, Goods from Head Office	4,070		
	4,760		
Less Stock, 31st December	740		
	4,020		
Gross Profit c/d .	2,194		
	£6,214		£6,214
To Rent, Rates and Taxes	160	By Gro[illegible]	2,194
Wages and Sundry Expenses	340		
Net Profit of Branch carried to G[illegible]al Profit and Loss Account . .	1,694		
	£2,194		£2,194

BRANCH TOTAL DEBTORS AND CASH SALES

			£				£
Jan	1	To Debtors b/f.	75	Dec	31	By Cash	6,200
		,, Trading Account Sales	6,214			,, Debtors c/f	89
			£6,289				£6,289
Jan	1	To Balance b/f					

GOODS SENT TO BRANCH ACCOUNT

							£
Dec	31	To Head Office Purchases Account	4,070	Dec	31	By Branch Stock Account	4,070

BRANCH STOCK ACCOUNT

			£				£
Jan	1	To Balance b/f.	690	Dec	31	By Balance, being Stock in hand c/f. ..	740
Dec	31	,, Goods sent to Branch Account	4,070			,, Branch Trading Account, cost of sales	4,020
			£4,760				£4,760
Jan.	1	To Balance c/f	740				

It will be observed that under this system the Branch Sales and gross profit are not incorporated in the General Trading Account, as in the system described in § 3 (*a*), but a separate Trading Account is prepared for the branch. Goods from head office are debited to Branch Stock Account and credited to goods sent to Branch Account, the Branch Stock Account being closed by transfer to the Branch Trading Account, and the goods sent to Branch Account by transfer to the Head Office Purchases Account. The Head Office Trading Account is thus relieved completely of the cost of the goods sent to the branch which are fully accounted for in the Branch Trading Account. The closing stock of the branch, at cost, instead of being included in the closing stock of the business credited to general Trading Account and carried forward in the general Stock Account, is carried forward in the Branch Stock Account, and the amount so carried forward will provide the Balance Sheet figure for this item.

(c) Where Goods charged to Branches at cost price plus a fixed percentage

As previously explained, when the selling prices of goods sent to branches can be predetermined without difficulty, all goods should be invoiced at those prices in order to obtain a check upon the stock and cash at the branches. Where it is not practicable to adopt a fixed gross profit percentage for all goods, the system described in § 3 (*a*) of this chapter should be used. In some cases, however, the nature of the business is such that the selling prices of all goods can be fixed by adding the same percentage to cost. In others, although the selling prices of particular lines of goods may be subject to fluctuation, experience may show that on the turnover as a whole a certain average percentage of gross profit may be expected. In such cases, it may be practicable to charge out all goods to branches at cost price plus a fixed percentage. The advantages of such a system are that in addition to providing a reasonably reliable check upon the stock and cash at the branch, since a record is available of the cost as well as the selling price of the goods the exact gross profit earned by each branch is disclosed by the accounts.

Under this system, in addition to the Branch Stock Account and the Goods sent to Branch Account, a Branch Stock Adjustment Account is maintained for each branch, to which account the amount of the 'loading' added to the cost of the goods sent to the branch is credited, and from which the actual gross profit of the branch can be ascertained. The entries in the accounts are as follows:

(1) Goods sent to branches are debited to the Branch Stock Account at the full *invoiced price*, Goods sent to Branch Account being credited with the *cost price* and Branch Stock Adjustment Account with the *profit percentage* added to cost. These entries are reversed in respect of goods returned by the branch to head office.

(2) Cash and credit sales are credited to Branch Stock Account, Cash and Total Debtors Account respectively being debited.

(3) At the close of the accounting period the stock on hand at the branch, valued at the price at which it was invoiced, is credited to the Branch Stock Account and carried forward to form the opening entry in that account in the new period. At the same time, the amount of the profit percentage included in such value is *debited* to the Branch Stock Adjustment Account and carried down to the *credit* of that account to form the opening entry in the new period.

(4) Assuming no difference to be disclosed in the Branch Stock Account after the invoiced price of the closing stock has been credited thereto, the balance remaining on the Branch Stock Adjustment Account should now represent the actual gross profit realised by the branch, since this account has been credited with the profit percentage added to cost on all goods sent to the branch, and debited with the profit percentage on such of those goods as have not been sold. This balance should be transferred from the Branch Stock Adjustment Account to the credit of the Branch Profit and Loss Account.

(5) For Balance Sheet purposes, the credit balance carried forward in the Branch Stock Adjustment Account will be set off against the debit balance carried forward in the Branch Stock Account to give the cost price of the stock on hand at the branch.

(6) The Goods sent to Branch Account, which has been credited with the *cost* price of the goods issued to the branch, will be closed by transfer to head office Purchases Account, thus relieving the Head Office Trading Account of the charge for these goods, which have been fully accounted for in the Branch Stock Account and the Adjustment Account.

(7) Any difference disclosed in the Branch Stock Account after the closing stock has been credited thereto, if reasonable in amount, may be regarded as the margin of error in computing the percentage to be added to cost, and should be transferred to the Adjustment Account before transferring the balance thereof to Profit and Loss Account. Differences beyond a reasonable limit should be investigated.

Illustration (1)

A company charges out goods to its branches at cost, plus 25 per cent. From the following particulars show the accounts of the branch in the head office books, indicating the actual profit made by the branch.

	£
Goods sent to branch	12,000
Goods returned to head office	1,000
Sales	10,400
Stock at commencement	1,500
Stock at close	2,120

BRANCH STOCK ACCOUNT

	£		£
To Stock b/f.	1,500	By Sales	10,400
" Goods from Head Office	12,000	" Returns to Head Office	1,000
" Adjustment Account, Apparent Profit	20	" Stock c/d	2,120
	£13,520		£13,520
To Balance – Stock b/d.	2,120		

BRANCH STOCK ADJUSTMENT ACCOUNT

	£		£
To 25% on cost of Returns	200	By Balance 25% on cost price of stock, b/f.	300
" 25% on cost price of Stock c/d.	424	" 25% on cost of goods transferred	2,400
" Profit and Loss Account, gross profit	2,096	" Branch Stock Account	20
	£2,720		£2,720
		By Balance b/d.	424

GOODS SENT TO BRANCH ACCOUNT

To Branch Stock Account – Cost of Returns	800	By Branch Stock Account, cost of goods sent to branch	9,600
,, Trading Account .	8,800		
	£9,600		£9,600

Notes:

(1) The credit balance carried down on the Branch Stock Adjustment Account of £424 will be deducted from the debit balance of £2,120 on the Branch Stock Account, to give the cost price of the stock for Balance Sheet purposes, *viz.*, £1,696.

(2) The gross profit of £2,096 is the balancing item on the Branch Stock Adjustment Account, after debiting the gross profit not earned, *viz.*, the addition to cost price on the goods returned to head office and the unsold stock.

As already stated, if a difference of unreasonable dimensions is disclosed in the Branch Stock Account, the cause must be investigated, and suitable adjusting entries made to give effect to it. Where, for example, the difference is found to be caused by the loss of goods (*e.g.* by destruction or theft), since the goods were never sold the gross profit on them has never been earned; the profit percentage added to the cost in respect thereof must therefore be debited to the Branch Stock Adjustment Account, and the cost price, being the amount of the loss actually sustained, to Profit and Loss Account (or, if the risk is covered by insurance to the Insurance Claim Account). Where, however, the difference is attributable to misappropriation of the cash proceeds of goods sold, no debit should be made to Branch Stock Adjustment Account, since the gross profit *has* been earned, and both the cost of the goods and the realised profit have been lost. The full invoice price of the goods should in this case be written off to Profit and Loss Account.

Illustration (2)

Goods are charged to branch at cost plus 20 per cent., and a shortage of £748 on the Branch Stock Account is found to be due to:

(1) Theft of Goods, £348.

(2) Theft of Cash, £400.

BRANCH STOCK ACCOUNT

	£			£
To Sundries (invoice price of goods cost plus 20 per cent.) . ..	12,000	By Sales . . .		8,852
		,, Goods stolen:		
		Profit and Loss Account	£290	
		Branch Adjustment Account	58	
				348
		,, Cash stolen Profit and Loss Account		400
		,, Stock c/d .		2,400
	£12,000			£12,000
To Balance b/d.	2,400			

BRANCH ADJUSTMENT ACCOUNT

	£		£
To Branch Stock Account 16⅔ per cent. on £348 Goods stolen	58	By Branch Stock Account (20 per cent. on £10,000)	2,000
,, Profit and Loss Account – Gross Profit .	1,542		
,, Balance c/d. being 16⅔ per cent on £2,400 Stock	400		
	£2,000		£2,000
		By Balance b/d	400

GOODS SENT TO BRANCHES ACCOUNT

	£		
To Purchases Account	10,000	By Branch Stock Account (cost of goods invoiced at £12,000)	

BRANCH PROFIT AND LOSS ACCOUNT

	£		£
To Branch Stock Account		By Branch Adjustment Account	
Cost of goods stolen	290	Gross Profit of Branch	1,542
Cash stolen ..	400		

An alternative method of dealing with the position where goods are charged out at cost plus a fixed percentage, is to rule the Branch Stock Account with two columns, one to record the invoice price of the goods, and the other their cost price. The entries in the invoice price columns form no part of the double entry, but are memoranda only, their purpose being to provide a check upon the stock. Where this system is adopted a Branch Stock Adjustment Account is not required, but the Branch Stock Account is maintained as if the goods were charged out at cost.

Illustration (3)

A Ltd. invoices its branch at cost, plus 33⅓%. From the following particulars prepare the Branch Stock Account as it would appear in the head office books:

	£
Stock at commencement, at invoice price . ..	3,000
Stock at close, at invoice price	2,400
Goods sent to branch during the year, at invoice price ..	20,000
Credit sales	1,000
Returns to head office, at invoice price .	1,000
Cash sales..	18,000
Invoice value of goods pilfered	200
Normal loss due to wastage and deterioration of stock .	300

BRANCH STOCK ACCOUNT

	Invoice Price (*memo*) £	£		Invoice Price (*memo*) £	
To Stock b/f.	3,000	2,250	By Branch Total Debtors Account.		
,, Goods from Head Office	20,000	15,000	Credit Sales	1,000	1,000
,, Gross Profit transferred to Profit and			Returns to Head Office .	1,000	750
Loss Account		4,450	Cash Sales	18,000	18,000
			Pilferage Account – Loss by theft	200	150
			Wastage and Deterioration	300	
			Apparent Loss .. .	100	
			Stock c/d. .	2,400	1,800
	£23,000	£21,700		£23,000	£21,700
To Stock b/d.	2,400	1,800			

Note:

It will be seen that no amount is extended into the outer column in respect of the normal wastage and the further small difference on the invoice columns, the loss in respect of these items being automatically reflected in the gross profit, the amount of which has been arrived at after crediting the account with the cost price of the actual stock on hand, in which these items are not included. Where, however, a difference on the invoice columns is found to be due to irregularities, adjusting entries will be necessary. If, for example the £300 represented the invoice price of goods lost or destroyed, the cost price thereof, *viz.* £200, should be

credited in the outer column of the Branch Stock Account and debited to Profit and Loss Account. If the whole of the £300 represented loss of cash, the full amount should be extended into the outer column and debited to Profit and Loss Account, as this would be the measure of the loss sustained.

Illustration (4)

R Ltd. own two retail shops, all goods being supplied from a main store at head office at cost plus 50 per cent. which is the selling price.

Cash takings are paid in daily to the bank to the credit of head office and all payments are made by head office. Only a small credit trade is done at the branches.

The following information is extracted from the books at head office and the branch returns for the year ended 31st December, 19...

	Head Office	Branch A	Branch B
	£	£	£
Stock, 31st December	6,040		
Stock at selling price, 1st January,		3,000	6,000
Goods sent to branches at selling price		10,800	19,500
Purchases	21,240		
Cash Sales paid into Bank		9,960	20,610
Credit Sales		750	600
Debtors, 1st January		500	400
Cash received from Debtors (paid into Bank)		850	700
Trade Creditors, 1st January	4,000		
,, ,, 31st December	4,500		
Bank Balance, 1st January	3,500		
Expenses paid	1,500	1,870	4,190
Sundry Assets, 1st January	10,000	8,000	7,000
Capital	32,500		
Profit and Loss Account, 1st January Credit Balance	3,900		

During the year Branch A had sent to Branch B goods to the value of £720 at selling price.

On stocktaking at 31st December, the Stock Account of Branch A showed a deficiency of £150, and that of Branch B a surplus of £90 at selling prices.

The head office expenses are to be apportioned equally between the two branches.

You are required to prepare:

(1) Cash Account for the year.
(2) Stock Account of each branch (in columnar form) in the head office books.
(3) Total Debtors Account for each branch.
(4) Profit and Loss Account for each branch.
(5) Balance Sheet at 31st December.

CASH ACCOUNT

		£			£
Jan. 1	To Balance b/f.	3,500	Dec. 31	By Expenses:	
Dec. 31	,, Branch A:			Head Office	1,500
	Cash Sales	9,960		Branch A	1,870
	Debtors	850		,, B	4,190
	,, Branch B:			,, Creditors	20,740
	Cash Sales	20,610		,, Balance c/f.	7,320
	Debtors	700			
		£35,620			£35,620
Jan.	To Balance b/d.	7,320			

TOTAL DEBTORS ACCOUNTS

		Branch A	Branch B			Branch A	Branch B
		£	£			£	£
Jan. 1	To Balances, b/f. ..	500	400	Dec. 31	By Cash	850	700
Dec. 31	" Credit Sales	750	600		" Balances b/f	400	300
		£1,250	£1,000			£1,250	£1,000
Jan. 1	To Balances b/d. ..	400	300				

BRANCH STOCK ACCOUNTS

		Branch A		Branch B				Branch A		Branch B	
		Invoice Price	*Dr.*	Invoice Price	*Dr.*			Invoice Price	*Cr.*	Invoice Price	*Cr.*
		£	£	£	£			£	£	£	£
Jan. 1	To Balance b/f. ..	3,000	2,000	6,000	4,000	Dec. 31	By Cash Sales	9,960	9,960	20,610	20,610
Dec. 31	" Goods from H.O.	10,800	7,200	19,500	13,000		" Credit Sales	750	750	600	600
	" Transfers ..	—	—	720	480		" Transfers	720	480	—	-
	" Surplus ..	—	—	90	—		" Deficiency	150	—	--	--
	" Gross Profit carried to Profit and Loss Account ..	—	3,470		7,130		Stock c	2,220	1,480	5,100	3,400
		£ 13,800	12,670	26,310	24,610			£ 13,800	12,670	26,310	24,610

Note

The entries in the 'Invoice Price' columns are merely memoranda. The profit and loss in respect of the surplus and deficiency in the closing stocks at the branch are automatically reflected in the gross profit, as the amounts entered in the 'credit' columns in respect of closing stock are the adjusted stock figures, reduced to cost.

PROFIT AND LOSS ACCOUNTS
FOR YEAR ENDED 31ST DECEMBER

	Branch A	Branch B		Branch A	Branch B
	£	£		£	£
To Expenses	1,870	4,190	By Gross Profit from Stock Accounts	3,470	7,130
" Head Office Expenses	750	750			
" Net Profit, to General Profit and Loss Account	850	2,190			
	£3,470	£7,130		£3,470	£7,130

BALANCE SHEET, 31ST DECEMBER

				H.O.	A.	B.	Total
Capital		32,500	Sundry Assets	10,000	8,000	7,000	25,000
Profit and Loss Account			Stock	6,040	1,480	3,400	10,920
Balance 1st July ..	3,900		Debtors	--	400	300	700
Net Profit for year:			Bank Balance	7,320	-	-	7,320
Branch A	850						
" B	2,190						
		6,940					
Trade Creditors		4,500					
		£43,940		£23,360	£9,880	£10,700	£43,940

§ 4. Branches which maintain separate accounting records

In the case of branches where, on account of their distance from the head office, or for some other reason, it is considered expedient to keep complete financial records at the branch, the following system should be employed:

There will be an account in the branch books called 'Head Office Current Account' (or 'Head Office Account') and in the head office books there will be a corresponding account called 'Branch Current Account' (or 'Branch Account'). All remittances of cash and transfers of goods, etc. to or from the head office, or other transactions between the head office and the branch will be passed through these accounts, either in detail or in total, at convenient intervals. In the branch books the Head Office Account can be regarded as the Capital Account of the branch, and consequently, if the assets in the branch books exceed the liabilities, the Head Office Account will show a credit balance. In the head office books the Branch Account will, in the same way, reveal a debit balance representing the excess of assets over liabilities at the branch.

At the end of each accounting period, the balance of the Profit and Loss Account in the books of the branch will be transferred to the Head Office Account, and the Branch Balance Sheet will then disclose the assets and the liabilities at the branch, and the balance due to or from the head office.

The head office, on receiving these accounts, will incorporate the profit at the branch in its own books by debiting the Branch Account and crediting Profit and Loss Account with the amount thereof. Assuming no other adjustments to be necessary, it will then be found that the balance on the Branch Account in the head office books agrees with the balance on the Head Office Account in the branch books. The head office and branch Balance Sheets can now be amalgamated, the various assets and liabilities being aggregated together under their respective headings, while the Current Account balances, being contra items, are eliminated.

Illustration (1)

The following are the trial balances of the head office and Leeds branch, respectively, of a business at 31st December. Prepare summarised amalgamated Balance Sheet and show the Leeds Current Account in the head office books.

DEBIT BALANCES	Head Office	Leeds
	£	£
Goodwill	5,000	
Stock	6,500	3,200
Debtors	7,300	4,100
Cash at Bank	2,100	520
Plant and Machinery	4,300	1,700
Leeds Current Account 1st Jan.	6,380	
Goods sent to Leeds	1,500	
Cash sent to London		2,000
	£33,080	£11,520
CREDIT BALANCES		
Share Capital – Authorised and Issued 21,000 Shares of £1 each, fully paid	21,000	
Profit and Loss Account – Balance at 1st Jan.	530	
" " " " Profit for year	6,200	1,900
Creditors	3,100	1,600
Provision for Bad Debts	250	140
Goods received from London		1,500
Cash received from Leeds	2,000	
Head Office Current Account 1st Jan.		6,380
	£33,080	£11,520

LEEDS CURRENT ACCOUNT IN HEAD OFFICE BOOKS

						£
Jan. 1	To Balance b/f.	6,380	Dec. 31	By Cash		2,000
Dec. 31	,, Goods	1,500		,, Balance c/d		7,780
	,, Profit and Loss Account: Profit	1,900				
		£9,780				£9,780
Jan. 1	To Balance b/d.	7,780				

BALANCE SHEET AS AT 31ST DECEMBER

	£	£		£	£	£
Share Capital Authorised and Issued: 21,000 Shares of £1 each, fully paid		21,000	Goodwill			5,000
			Plant and Machinery			
Profit and Loss Account:			Head Office		4,300	
Balance at 1st Jan.	530		Leeds		1,700	
Add Profit for year	8,100					6,000
		8,630	Stock.			
			Head Office		6,500	
		29,630	Leeds		3,200	
Sundry Creditors.						9,700
Head Office	3,100		Sundry Debtors			
Leeds	1,600		Head Office	£7,300		
		4,700	*Less* Provision	250		
					7,050	
			Leeds	4,100		
			Less Provision	140		
					3,960	
						11,010
			Cash:			
			Head Office		2,100	
			Leeds		520	
						2,620
		£34,330				£34,330

It will be seen that the Leeds Current Account is represented in the Balance Sheet by the net assets of the branch, *viz.*:

	£
Plant and Machinery	1,700
Stock	3,200
Debtors	3,960
Cash	520
	9,380
Less Creditors	1,600
	£7,780

Where, as frequently happens, cash or goods are in transit between the head office and the branches, or between one branch and another, at the date of the Balance Sheet, the balances of the relative Current Accounts will not agree, since the entries relating to the value in transit will have been made in one set of books, and not in the other. Before preparing the final accounts, therefore, adjustments are necessary in respect of these items. Where the cash or goods are in transit between a branch and its head office (*i.e.*, either from or to the head office), the adjustment in respect thereof will normally be made in the books of the head office, by crediting the Branch Account and debiting Cash or Goods in Transit Account with the amount in transit. Alternatively, the amount can be carried down as a separate balance in the Branch

Account to form an opening entry in the new period. In this manner the balance of the Branch Account in the head office books is reconciled with that appearing on the Head Office Account in the branch books, and no adjusting entries in the latter books are required.

Where the value in transit is between one branch and another, it is advisable for the adjustment to be made in the books of the transferor branch by crediting the account of the transferee branch and debiting a Cash or Goods in Transit Account, or carrying the amount down as a separate balance.

Illustration (2)

A company has its head office in London, and branches at Liverpool and Sheffield. The following are the separate Balance Sheets on 31st December:

LONDON

Share Capital:			Stock	36,250
100,000 Shares of £1 each fully paid		100,000	Debtors	42,500
Creditors		6,000	Sheffield Current Account (after debiting £300 Stock returned to Sheffield on 31st December, and received at Sheffield on 3rd January)	27,140
Liverpool Current Account (after debiting £100 Cash remitted on 31st December, and received at Liverpool on 1st January)		390	Cash at Bank	11,500
Profit and Loss Account:				
Balance at 1st Jan. . ..	£1,750			
Add Profit for year . .	9,250			
		11,000		
		£117,390		£117,390

LIVERPOOL

	£		£
Creditors	1,750	Stock	3,505
Bank Overdraft	4,000	Debtors	1,750
Sheffield Current Account (after debiting £150 Stock sent to Sheffield 31st December and received at Sheffield on 3rd January) . .	70	Head Office Current Account (after debiting £75 Stock sent to London 31st December and received at London on 2nd January)	
	£5,820		£5,820

SHEFFIELD

	£		
Creditors	5,050	Plant and Machinery ..	20,470
Head Office Current Account (after debiting £500 cash sent to Head Office 31st December and received at London 1st January)	26,340	Stock ..	5,200
		Debtors	3,250
		Liverpool Current Account	220
		Cash at Bank .	2,250
	£31,390		£31,390

The profit and loss balances at the branches have been adjusted.

Make the further adjustments necessary, and prepare aggregate Balance Sheet as at 31st December.

HEAD OFFICE BOOKS

LIVERPOOL CURRENT ACCOUNT

	£		£
To Balance c/d.	565	By Balance b/f.	390
		„ Stock in transit	75
		„ Cash in transit	100
	£565		£565
		By Balance b/d.	565

SHEFFIELD CURRENT ACCOUNT

	£		£
To Balance b/f.	27,140	By Cash in transit	500
		„ Stock in transit	300
		„ Balance c/d.	26,340
	£27,140		£27,140
To Balance b/d	26,340		

CASH IN TRANSIT

	£
To Liverpool Current Account	100
„ Sheffield Current Account	500

STOCK IN TRANSIT

	£
To Liverpool Current Account	75
Sheffield Current Account	300

LIVERPOOL BOOKS
SHEFFIELD CURRENT ACCOUNT

			£
		By Balance b/f.	70
		„ Stock in transit	150

STOCK IN TRANSIT

	£
To Sheffield Current Account	150

HEAD OFFICE CURRENT ACCOUNT

	£
To Balance b/f.	565

SHEFFIELD BOOKS
HEAD OFFICE CURRENT ACCOUNT

			£
		By Balance b/f.	26,340

LIVERPOOL CURRENT ACCOUNT

	£
To Balance b/f.	220

BALANCE SHEET AS AT 31ST DECEMBER

				£	£
Authorised and Issued Share Capital:			Plant and Machinery		20,470
100,000 Shares of £1 each fully paid		100,000	Stock:		
			London	36,250	
Profit and Loss Account:			Liverpool	3,505	
Balance at 1st Jan.	1,750		Sheffield	5,200	
Add Profit for year	9,250		Stock in transit	525	
		11,000			45,480
		111,000	Debtors:		
			London	42,500	
Creditors:			Liverpool	1,750	
London	6,000		Sheffield	3,250	
Liverpool	1,750				47,500
Sheffield	5,050		Cash at Bank:		
		12,800	London	11,500	
Bank Overdraft:			Sheffield	2,250	
Liverpool		4,000	Cash in transit	600	
					14,350
		£127,800			£127,800

In some cases it is more convenient to keep the accounts for fixed assets of the branch, such as land, buildings, plant and machinery, etc., in the head office books rather than in the branch books. If this system is adopted, the branch should be charged with depreciation on these assets, the Head Office Account in the branch books being credited, and Depreciation Account debited with the amount thereof. In the head office books the asset accounts concerned will be credited and the Branch Current Account debited with the amount of the depreciation. The transaction is equivalent to a transfer of value from the head office to the branch, which, in the head office books, must be charged to the branch and credited to the account giving the value, and in the branch books must be credited to the head office and debited to the account receiving the value.

In combining the final accounts of a business where there are only one or two branches, it is frequently found convenient to show the accounts in columnar form, columns being provided for the head office, for each branch, and for the total figures. When this is done, care should be taken to see that the amount of sales from the head office to branches, and the amount of purchases by branches from head office, together with any similar transactions as between the branches themselves, are not extended into the total column, otherwise the total figures will be unduly swollen by the inclusion of transactions which merely represent internal transfers and have no relation to the actual turnover. If the Balance Sheet is in columnar form, it will be necessary to include the balances of the Current Accounts between the head office and branches in the columns to which they relate, in order that the totals of these columns shall agree, but these Current Account balances must not be extended, since they represent the net assets or liabilities at the branches, which have already been included in the total columns.

When inter-branch transactions occur, each branch must have a Current Account for the branch with which the transactions are effected, and these accounts must be agreed at the end of each period in the same manner as the Current Accounts between the head office and branches.

Illustration (3)

A, B, and C are partners in a firm having separate businesses in London, Edinburgh, and Dublin. A manages in London, and receives two-thirds of the profits there, the balance being shared equally between B and C. B manages in Edinburgh, and receives half of the profits there, the balance being shared equally between A and C. C manages in Dublin, and receives one-third of the profits there, the balance being shared equally between A and B. The Capital Account of each partner is kept in the books of his branch. Each branch from time to time buys from and sells to the other branches at agreed rates sufficient to give the selling branch a reasonable profit on the handling of the goods, and such transactions have been adjusted through the Current Accounts.

From the following Trial Balances of the respective branches, prepare Columnar Trading and Profit and Loss Account for the year ended 31st December, and Columnar Balance Sheet as at that date. It is agreed that the special legal expenses incurred in London shall be borne by the three branches equally. Show the Current Accounts and Partners' Capital

Accounts in the books of each branch. Interest on capital to be charged at 5 per cent. per annum, but no interest on drawings. Provide depreciation on plant and machinery at 10 per cent. per annum. Closing stocks: London, £14,000; Edinburgh, £11,500; Dublin, £7,500.

TRIAL BALANCES, 31st December

Debit Balances	London	Edinburgh	Dublin	Credit Balances	London	Edinburgh	Dublin
	£	£	£		£	£	£
Stock 1st January	15,000	10,000	7,000	Sales ..	57,000	39,000	25,000
Purchases ..	40,000	25,000	12,000	Do. Internal	7,000	2,500	1,500
Do. Internal	1,000	4,000	6,000	Creditors ..	16,800	7,000	7,600
Wages ..	5,000	3,500	2,500	Current Accounts:			
Trade Expenses	4,900	2,900	1,550	London ..		3,000	2,000
Special Legal Expenses	600			Dublin ..		1,000	
Plant ..	7,000	4,000	3,000	Capital Accounts.			
Debtors ..	17,800	8,600	6,550	A	20,000		
Current Accounts:				B ..		8,000	
Edinburgh ..	3,000		1,000	C			5,000
Dublin ..	2,000						
Cash	2,500	1,500	500				
Drawing Accounts:							
A ..	2,000						
B ..		1,000					
C .			1,000				
	£100,800	£60,500	£41,100		£100,800	£60,500	£41,100

GENERAL TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31st December

	London	Edinburgh	Dublin	Total		London	Edinburgh	Dublin	Total
	£	£	£	£		£	£	£	£
To Stock 1st Jan. ..	15,000	10 000	7,000	32,000	By Sales ..	57,000	39,000	25,000	121,000
,, Purchases .	40,000	25,000	12,000	77,000	,, Do. Internal .	7,000	2,500	1,500	—
,, Do. Internal ..	1,000	4,000	6,000	—	,, Stock, 31st December	14,000	11,500	7,500	33,000
,, Wages	5,000	3,500	2,500	11,000					
,, Gross Profit c/d..	17,000	10,500	6,500	34,000					
	£78,000	£53,000	£34,000	£154,000		£78,000	£53,000	£34,000	£154,000
To Trade Expenses ..	4,900	2,900	1,550	9,350	By Gross Profit b/d	17,000	10,500	6,500	34,000
,, Special Legal Expenses ..	200	200	200	600					
,, Depreciation ..	700	400	300	1,400					
,, Interest on Capital	1,000	400	250	1,650					
,, Net Profit c/d. ..	10,200	6,600	4,200	21,000					
	£17,000	£10,500	£6,500	£34,000		£17,000	£10,500	£6,500	£34,000
To A	6,800	1,650	1,400	9,850	By Balance b/d. .	10,200	6,600	4,200	21,000
,, B	1,700	3,300	1,400	6,400					
,, C	1,700	1,650	1,400	4,750					
	£10,200	£6,600	£4,200	£21,000		£10,200	£6,600	£4,200	£21,000

LONDON BOOKS
A CAPITAL ACCOUNT

	£		£
To Drawings	2,000	By Balance b/f.	20,000
,, Balance c/d.	28,850	,, Interest on Capital	1,000
		,, Profit and Loss Account:	
		London Profit	6,800
		Edinburgh Profit	1,650
		Dublin Profit ..	1,400
	£30,850		£30,850
		By Balance b/d.	28,850

EDINBURGH CURRENT ACCOUNT

	£		£
To Balance b/f.	3,000	By Profit and Loss Account:	
„ A, Edinburgh Profit	1,650	London Profit, B	1,700
„ Law Charges .	200	„ Balance c/d. ..	3,150
	£4,850		£4,850
To Balance b/d.	3,150		

DUBLIN CURRENT ACCOUNT

	£		£
To Balance b/f	2,000	By Profit and Loss Account:	
„ A, Dublin Profit	1,400	London Profit, C	1,700
„ Law Charges	200	„ Balance c/d. .	1,900
	£3,600		£3,600
To Balance b/d.	1,900		

EDINBURGH BOOKS
B CAPITAL ACCOUNT

	£		£
To Drawings	1,000	By Balance b/f ..	
„ Balance c/d	13,800	„ Interest on Capital	
		„ Profit and Loss Account:	
		Edinburgh Profit	3,300
		London Profit .	1,700
		Dublin Profit ..	1,400
	£14,800		£14,800
		By Balance b/d.	13,800

LONDON CURRENT ACCOUNT

	£		£
To B, London Profit	1,700	By Balance b/f.	3,000
„ Balance c/d.	3,150	„ Law Charges ..	200
		„ Profit and Loss Account:	
		Edinburgh Profit, A	1,650
	£4,850		£4,850
		By Balance b/d	3,150

DUBLIN CURRENT ACCOUNT

			£
To B, Dublin Profit	1,400	By Balance b/f. ..	1,000
„ Balance c/d.	1,250	„ Profit and Loss Account:	
		Edinburgh Profit, C	1,650
	£2,650		£2,650
		By Balance b/d.	1,250

DUBLIN BOOKS
C CAPITAL ACCOUNT

	£		£
To Drawings	1,000	By Balance b/f. ..	5,000
„ Balance c/d	9,000	„ Interest on Capital	250
		„ Profit and Loss Account	
		Dublin Profit ..	1,400
		London Profit ..	1,700
		Edinburgh Profit	1,650
	£10,000		£10,000
		By Balance b/d. ..	9,000

LONDON CURRENT ACCOUNT

	£		£
To C, London Profit	1,700	By Balance b/f	2,000
" Balance c/d.	1,900	" Law Charges	200
		" Profit and Loss Account: Dublin Profit, A	1,400
	£3,600		£3,600
		By Balance b/d	1,900

EDINBURGH CURRENT ACCOUNT

	£		£
To Balance b/f.	1,000	By Profit and Loss Account: Dublin Profit B	1,400
" C, Edinburgh Profit	1,650	" Balance c/d	1,250
	£2,650		£2,650
To Balance b/d.	1,250		

A, B AND C
BALANCE SHEET AS AT 31ST DECEMBER

	London	Edinburgh	Dublin	Total		London	Edinburgh	Dublin	Total
	£	£	£	£		£	£	£	£
Creditors	16,800	7,000	7,600	31,400	Plant	6,300	3,600	2,700	12,600
Current Accounts:					Stock	14,000	11,500	7,500	33,000
London		3,150	1,900		Debtors	17,800	8,600	6,550	32,950
Dublin		1,250			Current Accounts:				
Capital Accounts:					Edinburgh	3,150		1,250	
A	28,850			28,850	Dublin	1,900			
B		13,800		13,800	Cash	2,500	1,500	500	4,500
C			9,000	9,000					
	£45,650	£25,200	£18,500	£83,050		£45,650	£25,200	£18,500	£83,050

Note

It will be observed that A's Capital Account, which appears in the London books, is credited with A's share of the Edinburgh and the Dublin profits, the Edinburgh and Dublin Current Accounts in the London books being debited. By these entries, the Edinburgh and Dublin branches become indebted to London for the London partner's share of their profits. The corresponding entries in the branch books are a credit to the London Current Account and a debit to Profit and Loss Account.

Similar entries are made in the respective books to record the fact that each of the branch partners is entitled to a share of the profits of the head office and of the other branch.

It will sometimes be found that although the branch keeps a complete set of books, the Capital and Current Accounts of the resident partner, as well as the fixed asset accounts of the branch, are kept in the head office books. Since no entries can be made direct from one set of books to another, all payments by the branch which have to be debited to accounts in the head office books, and *vice versa*, must be passed through the Current Accounts.

Illustration (4)

P and Q carry on a retail business in partnership. The business comprises two shops, one at London managed by P, and the other at Birmingham managed by Q. Each shop keeps complete double-entry books working up to a Profit and Loss Account, but accounts relating to capital and fixed assets are all kept in the London books.

Each partner takes half the net working profit of the shop he manages and the balance of revenue is divided between P and Q in the ratio of 3 to 2. No interest is allowed on the partners' capital, drawing or current accounts, but each shop is charged by way of rent with an amount equal to 5 per cent. on the book value of the shop buildings, this amount being credited to General Profit and Loss Account as interest.

The following were the trial balances extracted from the two sets of books as on 31st December, 19...

	London Dr.	London Cr.	Birmingham Dr.	Birmingham Cr.
	£	£	£	£
P Capital Account		35,000		
Current Account, 1st January ..		1,351		
Drawings	4,200			
Q - Capital Account		19,000		
Current Account, 1st January ..		708		
Drawings			2,700	
Freehold Buildings:				
London	16,000			
Birmingham	10,500			
Fixtures and Fittings, 1st January:				
London	1,660			
Birmingham	1,380			
Fixtures and Fittings added during year			70	
Stock-in-Trade, 1st January	10,510		8,305	
Purchases, *less* Returns	25,251		6,028	
Sales, *less* Returns		25,480		18,310
Bought Ledger Balances	12	615		261
Sales Ledger Balances	4,070	48	2,862	17
Salaries and Wages	1,806		1,266	
Sundry Trade Expenses	1,533		1,146	
Expenses accrued		107		62
Birmingham Current Account, 1st January	11,997			
London Current Account, 1st January ..				11,997
Remittances during year . ..		7,850	7,950	
Cash at Bank and in Hand . ..	1,240		320	
	£90,159	£90,159	£30,647	£30,647

Stocks on hand on 31st December were valued as follows: London, £12,330, Birmingham, £6,720.

During the year goods valued in all at £5,350 (at cost) had been forwarded by London to Birmingham, no entry in respect of these having been made in the books.

The discrepancy between the Remittances Accounts arose through a cheque for £100 being in the post at the end of the year.

£100 is to be provided for depreciation of the fixtures and fittings at London and £80 at Birmingham.

You are required to set out:

(1) Final Accounts of the business to 31st December, and

(2) The Birmingham Current Account in the London books.

(3) The London Current Account in the Birmingham books.

TRADING AND PROFIT AND LOSS ACCOUNTS
For the Year ended 31st December, 19..

	London	B'ham	Total		London	B'ham	Total
	£	£	£		£	£	£
To Stocks, 1st January	10,510	8,305	18,815	By Sales, *less* Returns	25,480	18,310	43,790
" Purchases, *less* Returns	25,251	6,028	31,279	" Transfer to Birmingham	5,350	–	–
" Transfer from London	—	5,350	—	" Stocks, 31st December	12,330	6,720	19,050
" Gross Profits, c/d. ..	7,399	5,347	12,746				
	£43,160	£25,030	£62,840		£43,160	£25,030	£62,840
To Rent	800	525	1,325	By Gross Profits, b/d.	7,399	5,347	12,746
" Salaries and Wages ..	1,806	1,266	3,072				
" Sundry Trade Expenses ..	1,533	1,146	2,679				
" Depreciation of Fixtures and Fittings	100	80	180				
Net Profits, c/d	3,160	2,330	5,490				
	£7,399	£5,347	£12,746		£7,399	£5,347	£12,746

To Division of Profit:			By Net Profits, b/d	
P $\frac{1}{2} \times$ £3,160	1,580		London	3,160
$\frac{3}{5} \times$ £4,070	2,442		Birmingham	2,330
		4,022	" Charges in lieu of rent.	
Q $\frac{1}{2}$ £2,330	1,165		London	800
£4,070	1,628		Birmingham	525
		2,793		
		£6,815		£6,815

P AND Q
Balance Sheet as at 31st December, 19

Capital Accounts				Freehold Buildings			
P		35,000		London		16,000	
Q		19,000		Birmingham		10,500	
			54,000				26,500
	P	Q		Fixtures and Fittings as at 1st January			
Current Accounts.	£	£		London	1,660		
Balance 1st January	1,351	708		*Less* Depreciation	100		
Share of Profit	4,022	2,793				1,560	
	5,373	3,501		Birmingham	1,380		
Less Drawings	4,200	2,700		Additions	70		
	£1,173	£801	1,974		1,450		
				Less Depreciation	80		
Sundry Creditors.						1,370	
London		770					2,930
Birmingham		340		Stock in Trade			
			1,110	London		12,330	
				Birmingham		6,720	
							19,050
				Sundry Debtors			
				London		4,082	
				Birmingham		2,862	
							6,944
				Cash at Bank and in Hand:			
				London		1,240	
				Birmingham		320	
						1,560	
						100	
							1,660
			£57,084				£57,084

BIRMINGHAM CURRENT ACCOUNT IN LONDON BOOKS

		£			£
Jan. 1	To Balance b/f.	11,997	Dec. 31	By Q, Current Account, Drawings	2,700
Dec. 31	" Trading Account: Goods to Birmingham ..	5,350		" Fixtures and Fittings Account: Additions during year ..	70
	" Fixtures Account – Depreciation	80		" Cash	7,850
	" Profit and Loss Account – Charge in lieu of Rent	525		" Cash in transit c/f.	100
	Net Profit	2,330		" Balance c/f. ..	9,562
		£20,282			£20,282

LONDON CURRENT ACCOUNT IN BIRMINGHAM BOOKS

		£			£
Dec. 31	To Cash – Remittances .	7,950	Jan. 1	By Balance b/f.	11,997
	„ „ Q's Drawings ..	2,700	Dec. 31	„ Trading Account – Goods from London	5,350
	„ „ Purchase of Fixtures	70		„ Profit and Loss Account:	
	„ Balance c/f. . ..	9,562		Depreciation of Fixtures . .	80
				Charge in lieu of Rent	525
				Net Profit	2,330
		£20,282			£20,282

Notes

(1) In this case, although the Birmingham branch keeps complete double-entry books and prepares its own Profit and Loss Account, the Fixed Asset Accounts of the branch and the resident partner's Capital and Current Accounts are kept in the London books. Payments made at the branch in respect of Q's drawings and the purchase of fixed assets are therefore analogous to remittances to head office and must be debited to the London Current Account in the branch books. In the London books these amounts are credited to the Branch Current Account, and debited to Q's Current Account and Fixtures Account respectively.

Depreciation of the fixed assets is debited to Profit and Loss Account and credited to London Current Account in the Birmingham books, whilst in the London books it is debited to the Birmingham Current Account and credited to the fixed asset accounts.

The charge in lieu of rent is similarly treated in the branch books, as it represents the cost of a service received from the head office. In the London books it is debited to the Birmingham Current Account and credited to Profit and Loss Account.

(2) The balance on the Current Accounts represents the Birmingham capital, *i.e.*, the assets, *less* liabilities, appearing in the Birmingham books, and included in the firm's Balance Sheet, *viz.*:

	£
Stock-in-Trade	6,720
Sundry Debtors	2,862
Cash	320
	9,902
Less Creditors	340
	£9,562

It may be desired to record in the head office books at the end of each accounting period the whole of the revenue balances of the branch instead of merely the final balance of the Branch Profit and Loss Account. In this manner the head office revenue accounts will reveal the position of the business as a whole, and by extracting a Trial Balance from the head office books, a combined Trading and Profit and Loss Account of the head office and branch can be prepared.

Illustration (5)

The undermentioned trial balance, extracted from the books of its branch, is received by the X Trading Co. Ltd.

Show by journal entries the incorporation of the revenue balances in the books of the head office.

TRIAL BALANCE, 31st December, 19..

	£	£
Head Office Account		10,192
Freehold Premises .. .	15,000	
Stock, 1st January .. .	10,164	
Purchases	35,649	
Goods from Head Office .	10,500	
Bank Interest ..		
Wages	5,642	
Rates, Insurance, etc.	1,520	
Salaries and Office Expenses	3,192	
Advertising ..	3,429	
Sundry Debtors .	4,439	
Rents Receivable		200
Sundry Creditors ..		5,684
Sales .. .		75,326
Cash at Bank and in Hand		
	£91,422	£91,422
Stock, 31st December	£8,392	

JOURNAL

		£	£
Sundries	Dr.		
To Sundries:			
Stock		10,164	
Purchases ..		35,649	
Goods sent to Branch Account		10,500	
Wages .		5,642	
Rates, Insurance, etc		1,520	
Salaries and Office Expenses		3,192	
Advertising		3,429	
Branch Account		5 450	
Sales ..			75,326
Bank Interest ..			20
Rents Receivable			200
		£75,546	£75,546
Incorporation of branch trading transactions for the year ended 31st December, 19 .	—		
Branch Account ..	Dr.	8,392	
To Trading Account			8,392
Branch Stock at 31st December, 19			

The Branch Account in the head office books, will now appear as under:

BRANCH ACCOUNT

19		£	19		£
Dec. 31	To Balance b/f . .	10,192	Dec. 31	By Balance c/f	24,034
	,, Sundries .. .	5,450			
	,, Trading Account - Stock ..	8,392			
		£24,034			£24,034
19..					
Jan. 1	To Balance b/d				

The above balance will be represented by the branch assets and liabilities, as under:

	£
Freehold Premises ..	15,000
Stock	8,392
Cash at Bank and in hand	1,887
Sundry Debtors ..	4,439
	29,718
Less Sundry Creditors	5,684
	£24,034

Note

It will be observed that the effect of the above entries is to debit the Branch Account with the net profit made by the branch for the year. The separate Branch Trading and Profit and Loss Account would have appeared as under:

BRANCH TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 19..

	£		£
To Stock, 1st January ..	10,164	By Sales	75,326
„ Purchases	35,649	„ Stock, 31st December	8,392
„ Goods from Head Office ..	10,500		
„ Gross Profit c/d	27,405		
	£83,718		£83,718
To Wages	5,642	By Gross Profit b/d. ..	27,405
„ Salaries and Office Expenses	3,192	„ Bank Interest ..	20
„ Rates, Insurance, etc.	1,520	„ Rents Receivable	200
„ Advertising	3,429		
„ Net Profit	13,842		
	£27,625		£27,625

The closing balance on the Branch Account shown above is reconciled as under:

	£
Balance brought forward	10,192
Profit as per above account	13,842
Closing balance	£24,034

As the branch revenue balances are amalgamated with those of the head office, the goods from head office must be debited to Goods sent to Branch Account in the head office books in order to eliminate the internal transfer. It will be appreciated that these goods are already included in the head office purchases.

§ 5. Foreign Exchanges

Foreign exchange is a term which denotes:

(1) the exchange of the currency of one country for the currency of another country: *and*

(2) the means whereby such exchange is effected.

If the list of foreign exchange quotations set out in any newspaper is examined it will be seen that:

(1) Certain quotations are in terms of the number of units of foreign currency which are equivalent to the £. These quotations are usually called '*Currency*' or '*Movable*'. Examples are Italy (lire to the £), Belgium (francs to the £), and the United States (dollars to the £).

(2) Other quotations are in terms of the amount of sterling which is equivalent to one unit of foreign currency. These quotations are usually called '*Pence*' or '*Fixed*'. Examples are India (pence to the rupee), Japan (pence to the yen), and China (pence to the dollar).

The terms 'Currency or Movable' and 'Pence or Fixed' refer *only* to the *method* of quoting which is employed, and do *not* refer in any way to the presence or absence of *fluctuation* in the quoted rates. They are alternative methods of expressing the same fact.

The distinction between these two methods of quoting must be kept clearly in mind, as a *rise* in a 'Fixed' quotation has the same effect as a *fall* in a 'Movable' quotation, and a *fall* in a 'Fixed' quotation has the same effect as a *rise* in a 'Movable' quotation.

Each country has its own currency. This is the case even where the units of currency of two or more countries have the same designation. South African pounds, Australian pounds and English pounds must each be kept quite distinct in the mind. A debtor, whose obligation is payable in Australian pounds, cannot be required to discharge his liability in English pounds.

The pound sterling is legal tender in this country only and not elsewhere. Similarly, the Belgian franc is legal tender in Belgium but is not generally acceptable in discharge of a debt payable in this country in terms of sterling.

It is apparent, therefore, that where transactions are entered into between persons or firms in different countries certain complications may arise by reason of exchange fluctuations. If, for example, A buys goods from B in France at an agreed sterling price, any fluctuation in the franc rate will not concern A, but it will affect the franc value of the sterling received by B. Where, therefore, a trader purchases or sells goods in a currency other than his own, unless the transaction is left unrecorded until the sterling figure is known, some adjustment will be required when payment is actually made or received. This adjustment will be in respect of the difference between the figures recorded in sterling at the time the transaction is entered into and the actual sterling figures which result when the transaction is completed, and will represent a profit or loss on exchange.

Illustration

A in London purchases goods from B & Company in Ruritania, for 130,000 crowns. B & Company's accounts in A's ledger shows a credit balance of £1,000, A having converted the crowns into sterling at the rate of 130.000. A desires to pay B & Company, and for that purpose purchases in London a draft on Ruritania for 130,000 crowns, at the rate of 131.00.

Make the entries in A's Books, posting up and balancing off B & Company's Account.

A's BOOKS
B & COMPANY'S ACCOUNT

	Crowns	Sterling £	s	d		Crowns	Sterling £	s	d.
To Cash for Draft	130,000	992	7	4	By Balance b/f.	130,000	1,000	0	0
" Profit on Exchange .		7	12	8					
	130,000	£1,000	0	0		130,000	£1,000	0	0

§ 6. Foreign Branches

Where branches of a business are situated abroad and are of a trading or manufacturing nature, it will usually be found necessary to keep the whole of the detail accounts at the branch, and consequently the system described in § 4 will be applied.

The Branch Account in the head office books should be ruled with two columns, one for the foreign currency and the other for sterling. The entries in the currency

columns will be memoranda only, but are necessary to facilitate reconciliation with the Head Office Account in the branch books which, of course, will record the transactions in the currency of the country in which the branch is situated.

At the conclusion of an accounting period the branch will forward to its head office a copy of its Trading and Profit and Loss Account, and of its Balance Sheet, together with a detailed copy of its Head Office Account. It will be necessary to incorporate the results shown by the branch accounts in the accounts of the head office in the same manner as that described in § 4, but before this can be done the branch figures, which are in local currency, must be converted into sterling.

The rate or rates of exchange at which the branch assets, liabilities, and revenue items are converted into sterling will depend upon whether the rate of exchange between the countries of the branch and head office is reasonably stable, or is subject to material fluctuation. It will be apparent that a method suitable where little or no fluctuation in the rate of exchange takes place would yield most unsatisfactory results in those cases where exchange fluctuations are considerable.

(a) Branches working on a fixed rate of exchange

Where the rate of exchange between the countries of the head office and branch is so stable that fluctuations can be disregarded, it is usual to convert all branch balances, except remittances of cash, into sterling at a fixed rate of exchange, and as a result a difference on exchange will only arise in connection with the remittances of cash to and from the branch, which will be converted at their actual cost or at the amount of sterling realised.

The currency balance on the Head Office Account will be automatically converted by inserting in its place in the converted Trial Balance the sterling balance appearing on the Branch Account in the head office books. The difference between the conversion of remittances at the actual and fixed rates respectively will represent profit or loss on exchange, and will be debited or credited to the Branch Account in the head office books, and credited or debited to Difference on Exchange Account.

Illustration

The following are the final balances of a branch in Illyria at 31st December. Convert at the fixed rate of exchange of $4.90 to the £. The cash remitted from Illyria appeared in the London books as £98 6s. 6d. Make the necessary adjustments in the London books by journal entry, and show the Branch Account in the London books, and the London Account in the branch books.

FINAL BALANCES, 31st December

Cash at Bank ..	1,161·25	
Cash in Hand ..	109 59	
Stock, 31st December	5,387·02	
Plant	4,931·94	
Office Furniture ..	470·59	
Provision for Bad Debt		810 82
Land and Premises	11,524·75	
Debtors	8,389·49	
Profit and Loss Account – Profit for year		991·04
Creditors		10,935·45
Remittances to London .. .	480·19	
Head Office Account – Balance at 1st January		19,717·51
	$32,454 82	$32,454·82

RULE FOR CONVERTING CURRENCY INTO STERLING WHEN THE RATE IS PER £

Divide the currency figure by the rate of exchange, and the quotient will be £ sterling: the decimal remainder must then be converted into shillings and pence.

FINAL BALANCES, 31ST DECEMBER, CONVERTED AT $4.90 PER £

	£ s. d.	s. d.
Cash at Bank	236 19 9	
Cash in Hand	22 7 4	
Stock 31st December	1,099 7 10	
Plant	1,006 10 4	
Office Furniture	96 0 9	
Provision for Bad Debts . .		165 9 6
Land and Premises ..	2,351 19 9	
Debtors	1,712 2 10	
Profit and Loss Account – Profit for year		202 5 1
Creditors		2,231 14 6
Remittances to London (actual rate)		
Head Office Account – Balance at 1st January		4,023 19
Difference in Exchange (Profit)		6
	£6,623 15 1	£6,623 15 1

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		£ s. d.	£ s. d.
Dec. 31	Illyria Current Account .. To Difference on Exchange Account Being difference in exchange on remittances	6 5	6 5
Dec. 31	Illyria Current Account To Profit and Loss Account Being $991 04 profit for year @ $4 90 per £	202 5 1	202 5 1

LONDON LEDGER
ILLYRIA ACCOUNT

		Dollars	Sterling £ s. d.			Dollars	Sterling £ s. d.
Jan 1	To Balance	19,717·51	4,023 19 7	Dec. 31	By Remittances	480 19	98 6 6
Dec 31	,, Difference on Exchange .		6 5		,, Balance	20,228 36	4,128 4 7
	,, Profit and Loss Account: Profit for year	991·04	202 5 1				
		$20,708·55	£4,226 11 1			$20,708 55	£4,226 11 1
Jan 1	To Balance	20,228·36	4,128 4 7				

ILLYRIA LEDGER
LONDON ACCOUNT

		Dollars			Dollars
Dec. 31	To Remittances	480 19	Jan. 1	By Balance ..	19,717 51
	,, Balance ..	20,228 36	Dec 31	,, Profit and Loss Account. Profit for year	991 04
		$20,708 55			$20,708·55
			Jan 1	By Balance ..	20,228 36

Note

It is not usual to provide memoranda sterling columns in the branch books, though this can be done if desired.

(b) Branches working on a fluctuating rate of exchange

Where the exchange is of such a fluctuating nature that to work on a fixed basis would give a misleading result, the branch balances are usually converted on the following principles:

(1) *Fixed assets* at the rate prevailing when they were purchased (if they were purchased from currency funds) or at the actual cost of a remittance sent by head office for the purpose of the purchase. Renewals of, and additions to, fixed assets will be converted on the same principle, but where small additions are made throughout the year the average rate for the year could be used therefor. It may also be necessary to take an average for a period where major additions are paid for by instalments.

The charge for depreciation of fixed assets must be converted at the same rate as the assets concerned.

It is obvious that a fixed asset, having been converted at a rate that remains in force from year to year, so far as that asset is concerned, the depreciation must be converted at the same rate, if the sterling value is to be written off or reduced to scrap value over the requisite period. Where exchanges have fluctuated greatly, however, it may be necessary, in order to avoid misleading results, to charge the depreciation to Profit and Loss Account at the average rate for the period. Any difference between the amount so charged and the amount credited to the Provision for Depreciation Account is then credited to Reserve (if a profit) or debited to the Appropriation Account (if a loss).

Illustration (1)

Fixed plant purchased for 750,000 bancos when the banco was at 75, stands in the branch books at 450,000 bancos. During the year under review, the branch wrote off 90,000 bancos depreciation. The average rate for the year was 106. How should the depreciation be converted into sterling?

For the purposes of the Asset Account, the depreciation must be converted at 75, giving a sterling figure of £1,200. For the purposes of the Profit and Loss Account, however, it would preferably be converted at 106, giving a sterling figure (approx.) of £849. Appropriation Account should be debited with the difference of £351.

It will be seen that the above treatment is accurate when it is considered that by writing off depreciation, the branch is setting aside current revenue (converted at the average rate), and if the head office does not provide an equivalent amount, the two sets of books may show grossly misleading results.

(2) *Long-term liabilities* on the same basis as fixed assets, but a provision may become necessary to meet a fall in the value of the £ when this is permanent (*see* below).

(3) *Current assets and liabilities* at the rate ruling at the date of the Balance Sheet, *i.e.*, at the rate which would give the amount of sterling which would be received or paid if the assets were realised and the liabilities paid on that date.

(4) *Revenue* balances at the average rate for the period to which they relate.

(5) *Remittances* at their actual cost or realised sterling.

The reason why fixed assets continue to be converted at the same rate from year to year, although the exchange may vary, is that such assets remain in the country itself, and are not, in the ordinary way, subject to conversion into cash in the same manner as current assets. Even though the rate of exchange depreciates permanently, it may not be necessary to make a special provision for such loss on exchange in the case of fixed assets, if the rate at which such assets are being depreciated is a satisfactory one and will reduce their sterling cost to nil or scrap value at the end of their effective life.

Where, however, the asset will have to be replaced at the end of its effective life, a provision is desirable, and may be created by the expedient already mentioned, of charging depreciation at current rates to Profit and Loss Account. Then, when the fixed asset is replaced out of current assets, the difference on exchange will be met by the provision.

Illustration (2)

Plant was purchased for 500,000 francs when the franc stood at 200 to the £, and has been depreciated over 10 years by 50,000 francs per annum. Today the plant is replaced at a cost of 530,000 francs, the franc being quoted at 106 to the £.

In the branch books, the depreciation written off has provided 500,000 francs, leaving only 30,000 francs to be found out of capital. In the head office books, however, 530,000 francs, included therein as current assets converted at 106   £5,000 has been capitalised, although only 500,000 francs, converted at 200   £2,500, has been provided over the lifetime of the plant. If, however, the depreciation has been provided as suggested above, at the current rates year by year, there will be a provision to meet the difference, *e.g.*, if the average rate for ten years has been 80, the position will be that Profit and Loss Account has been debited with £6,250, the Plant Account credited with £2,500, and provision with £3,750. £2,500 of the latter will meet the additional expenditure. From this it will be seen that the allocation to provision should have ceased when it amounted to the total current value of the original plant, the excess depreciation in these years being written back to the credit of Appropriation Account.

In the case of long-term liabilities which have to be repaid out of current assets, it is essential to provide out of Appropriation Account over a period of years for any permanent depreciation in sterling exchange.

Illustration (3)

A loan of 2,000,000 francs was contracted when the franc was quoted at 200 and therefore appears in the head office accounts at £10,000. The franc appreciated to 75, and later depreciated to 130. The loan is repayable shortly.

On repayment, there will be disbursed from the branch currency 2,000,000 francs, which, as current assets with the franc at 130, stand in the head office books at £15,385. If no provision has been made, there will remain a 'loss' of £5,385 in the head office books. Obviously, therefore, provision should have been made year by year as the franc appreciated (*i.e.*, sterling depreciated), to ensure that this loss does not fall on any one year. Equally obviously, the loss cannot be forecast exactly, but must be provided for as accurately as possible.

The average rate for the conversion of revenue balances will be taken either from the average of the rates published at regular intervals, or by taking the rate at a given day of each month during the period, adding such rates together and dividing the total by the number of months.

These general rules are subject to modifications in certain circumstances, *e.g.*, in connection with Stores and Stock Accounts, which it is customary to adjust on a standard basis, so that no profit or loss on exchange is written off in respect of the conversion of the stocks in hand at the end of each balancing period. It may also be necessary to 'weight' the average where an unduly large number of transactions, or transactions greatly varying in amount, have taken place during a particular period.

The branch Trial Balance will be ruled with two additional sterling columns, a further column being provided for the appropriate rate of exchange, and each item will be converted at its proper rate, with the exception of the opening balance on the Head Office Account, which will be taken at the sterling figure as shown in the last accounts. It is convenient to show the remittances and other items relating to the head office separately in the branch Trial Balance, and to leave the Head Office Current Account at its opening figure until the conversions have been made, owing to the different rates of exchange at which the various classes of item must be converted.

The sterling columns of the Trial Balance will be cast, and the difference thereon will represent the difference on exchange, which will be adjusted through the Branch Account in the head office books in the manner previously explained. If the difference is a profit, it is advisable to carry the amount forward on Exchange Provision Account, since the fluctuation of the exchange may possibly result in a loss during the succeeding period; if the difference is a loss, it should be written off to the Exchange Provision Account (if any) or to Profit and Loss Account.

Whilst in practice foreign branches would most probably prepare their own Profit and Loss Accounts locally, details of income and expenditure must be supplied to the head office to enable the conversion at the appropriate rates to be effected.

Illustration (4)

The following is the London trial balance of the Ruritania Trading Co., Ltd., at 31st December:

	£	£
Share Capital:		
Authorised, 50,000 Shares of £1 each		
Issued, 33,000 Shares fully paid		33,000
Office Expenses	250	
Directors' Fees	500	
Sundry Creditors		100
Salaries	300	
Profit and Loss Account – Balance brought forward		887
Cash at Bank	2,000	
Remittances from Ruritania		2,750
Ruritania Branch Account	33,915	
Difference on Exchange Account – Balance at 1st January		228
	£36,965	£36,965

The following is the trial balance as at 31st December, sent to the head office by the Ruritania Branch:

	Crowns	Crowns
Stock as at 1st January ..	65,000	
Purchases	120,000	
do. Returns .		6,000
Sales ..		190,000
Wages and Salaries .	18,000	
Office Expenses	15,000	
Carriage and Insurance .	5,000	
Bad Debts . .	3,000	
Depreciation, Leasehold Premises	4,000	
„ Furniture and Fittings	500	
Cash at Bank	12,000	
Sundry Creditors		32,000
Sundry Debtors	35,500	
Leasehold Premises	66,000	
Furniture and Fittings	2,000	
Remittances to Head Office .	11,200	
Head Office Account		129,200
	Cr. 357,200	Cr 357,200

Stock on hand at 31st December was valued at 60,000 Crowns.

The leasehold premises were acquired when the rate of exchange was 4/10 per crown, and furniture and fittings at an average rate of 4/11. The rate ruling on 1st January was 5/3, on 31st December, 4/9, and the average rate during the year was 5/ .

Convert the foreign trial balance, showing the difference on exchange. Prepare Profit and Loss Account and Balance Sheet of the company, and show the Branch Account in the head office books, and the Head Office Account in the branch books.

CONVERSION OF RURITANIA TRIAL BALANCE

	Rate of Exchange		Dr. Crowns	Cr Crowns	Dr Sterling			Cr Sterling		
	s.	d.			£	s	d	£	s.	d
Stock as at 1st January ..	5	3	65,000		17,062	10	0			
Purchases	5	0	120,000		30,000	0	0			
„ Returns .	5	0		6,000				1,500	0	0
Sales	5	0		190,000				47,500	0	0
Wages and Salaries .	5	0	18,000		4,500	0	0			
Office Expenses ..	5	0	15,000		3,750	0	0			
Carriage and Insurance	5	0	5,000		1,250	0	0			
Bad Debts ..	5	0	3,000		750	0	0			
Depreciation, Leasehold Premises	4	10	4,000		966	13	4			
do. Furniture and Fittings	4	11	500		122	18	4			
Cash at Bank ..	4	9	12,000		2,850	0	0			
Sundry Creditors ..	4	9		32,000				7,600	0	0
Sundry Debtors ..	4	9	35,500		8,431	5	0			
Leasehold Premises	4	10	66,000		15,950	0	0			
Furniture and Fittings .	4	11	2,000		491	13	4			
Remittances to Head Office			11,200		2,750	0	0			
Head Office Account				129,200				33,915	0	0
Difference on Exchange .					1,640	0	0			
			357,200	357,200	£90,515	0	0	£90,515	0	0
Stock on Hand at 31st December								14,250	0	0

RURITANIA BRANCH PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER

	£	s.	d.	£	s.	d.		£	s.	d.
To Stock ..				17,062	10	0	By Sales	47,500	0	0
„ Purchases ..	30,000	0	0				„ Stock	14,250	0	0
Less Returns	1,500	0	0							
				28,500	0	0				
„ Balance, being Gross Profit c/d.				16,187	10	0				
				£61,750	0	0		£61 750	0	0

RURITANIA BRANCH PROFIT AND LOSS ACCOUNT (*continued*)

		£ s. d.		£ s. d.
To Wages and Salaries		4,500 0 0	By Balance b/d	16,187 10 0
" Office Expenses		3,750 0 0		
" Carriage and Insurance		1,250 0 0		
" Bad Debts		750 0 0		
" Depreciation, Leasehold Premises	£966 13 4			
" Furniture and Fittings	122 18 4			
		1,089 11 8		
" Balance, Net Profit at Branch c/d.		4,847 18 4		
		£16,187 10 0		£16,187 10 0
To London Office Expenses:				
Office Expenses		250 0 0		
Directors' Fees		500 0 0	By Balance b/d	4,847 18 4
Salaries		300 0 0		
" Difference on Exchange		1,412 0 0		
" Balance, being Net Profit carried forward		2,385 18 4		
		£4,847 18 4		£4,847 18 4

HEAD OFFICE BOOKS
RURITANIA BRANCH ACCOUNT

		Crowns	Sterling £ s. d.			Crowns	Sterling £ s. d.
Jan. 1	To Balance b/f.	129,200	33,915 0 0	Dec. 31	By Remittances	11,200	2,750 0 0
Dec. 31	" Profit and Loss Account: Profit for Year	25,500	4,847 18 4		" Difference on Exchange		1,640 0 0
					" Balance c/d.	143,500	34,372 18 4
		154,700	£38,762 18 4			154,700	£38,762 18 4
Jan 1	To Balance b/d.	143,500	34,372 18 4				

RURITANIA BRANCH BOOKS
HEAD OFFICE ACCOUNT

		Crowns			Crowns
Dec. 31	To Remittances	11,200	Jan. 1	By Balance b/f.	129,200
	" Balance c/d.	143,500	Dec. 31	" Profit and Loss Account	25,500
		154,700			154,700
			Jan. 1	By Balance b/d.	143,500

BALANCE SHEET AS AT 31ST DECEMBER

	£ s. d.	s. d.		£ s. d.	s. d.
Authorised Share Capital: 50,000 Shares of £1 each	50,000 0 0		Leasehold Premises	16,916 13 4	
			Less Depreciation for year	966 13 4	
					15,950 0 0
Issued Share Capital: 33,000 Shares of £1 each fully paid		33,000 0 0	Furniture and Fittings	614 11 8	
			Less Depreciation for year	122 18 4	
					491 13 4
Profit and Loss Account:			Stock on hand		14,250 0 0
Balance at 1st Jan	887 0 0		Sundry Debtors		8,431 5 0
Profit for year	2,385 18 4		Cash at Bank:		
			Ruritania	2,850 0 0	
		3,272 18 4	London	2,000 0 0	
		36,272 18 4			4,850 0 0
Sundry Creditors: Ruritania London		7,700 0 0			
		£43,972 18 4			£43,972 18 4

Notes

(1) Since there was a loss on exchange during the year, this has been written off, after taking into account the credit balance on Difference on Exchange Account brought forward.

(2) The currency figure representing profit for the year inserted in the Branch Account at the head office is ascertained by extracting the profit and loss items from the branch trial balance.

(3) It should be observed that the final sterling balance of the Ruritania Branch Account does not represent the conversion of the currency balance at any of the rates given, since it is composed of various assets and liabilities converted at different rates. The sterling balance of the Branch Account must always agree with the sterling figures of the net assets at the branch concerned.

(4) Bad debts incurred during the year must be converted into sterling at the average rate. A bad debts provision, however, created against the outstanding debtors, must be converted at the same rate as the debtors to which it relates, *viz.*, the rate at the date of the Balance Sheet.

In the preceding illustration the opening and closing stocks have been converted at the opening and closing rates of exchange respectively, while the purchases and sales have been converted at the average rate for the period. The effect of converting Trading Account figures at different rates is to cause the gross profit in terms of sterling to be vitiated by the intrusion of exchange variations, and thereby to render the accounts less effective as a means of comparison with other periods, and of control. The practice is frequently adopted, therefore, of converting all items entering into the Trading Account either at a fixed rate, or at the average rate for the period, at the same time converting the closing stock *for the purposes of the Balance Sheet* at the rate ruling at the date of the Balance Sheet. By this means, the gross profit is not distorted by exchange fluctuations, but any difference on exchange affecting stock valuations is reflected in the Profit and Loss Account, and the correct basis of valuation of the stock is employed for the purpose of the Balance Sheet.

Illustration (5)

During the year ended 31st March, P Ltd. opened a foreign branch for the purpose of trading in the company's products. The branch converts head office invoices for goods at a fixed exchange rate of 80 unitas to the £.

The branch trial balance at 31st March was as follows:

	Dr. Unitas	*Cr.* Unitas
Balance at Bank	366,400	
Creditors		235,800
Debtors	777,600	
Local Expenses	754,200	
Head Office Account (for goods)		3,524,800
Remittances to head office ..	2,690,000	
Purchases	3,524,800	
Sales		4,352,400
	U.8,113,000	U.8,113,000

Stocks at 31st March, U.1,045,600.

The average rate of exchange during the period was 90, and the closing rate 100. The remittances realised £35,000.

You are required to:

(*a*) prepare the converted trial balance of the branch for incorporation in the head office books;

(*b*) to show the Trading and Profit and Loss Account of the branch; and

(*c*) to show the Branch Account in the head office books.

(*a*) BRANCH TRIAL BALANCE

	Dr. Unitas	*Cr.* Unitas	Rate	*Dr.* £	*Cr.* £
Balance at Bank	366,400		100	3,664	
Creditors		235,800	100		2,358
Debtors	777,600		100	7,776	
Local Expenses	754,200		90	8,380	
Head Office Account		3,524,800	80		44,060
Remittances to Head Office	2,690,000		Actual	35,000	
Goods from Head Office	3,524,800		80	44,060	
Sales		4,352,400	80		54,405
Stocks 31st March:					
For Trading Account		1,045,600	80		13,070
„ Balance Sheet	1,045,600		100	10,456	
	U.9,158,600	U.9,158,600		109,336	113,893
Loss on Exchange				4,557	
				£113,893	£113,893

(*b*) BRANCH TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 31ST MARCH

	Unitas	£		Unitas	£
To Purchases	3,524,800	44,060	By Sales	4,352,400	54,405
„ Gross Profit c/d.	1,873,200	23,415	„ Stock	1,045,600	13,070
	5,398,000	£67,475		5,398,000	£67,475
To Local Expenses	754,200	8,380	By Gross Profit	1,873,200	23,415
„ Net Profit	1,119,000	15,035			
	U.1,873,200	£23,415		U.1,873,200	£23,415

(*c*) BRANCH ACCOUNT

	Unitas	£		Unitas	£
To Goods	3,524,800	44,060	By Remittances	2,690,000	35,000
„ Net Profit	1,119,000	15,035	„ Loss on Exchange		4,557
			„ Balance c/f.	1 953,800	19,538
	U.4,643,800	£59,095		U.4,643,800	£59,095
To Balance b/d.	U.1,953,800	£19,538			

Notes

(1) The balance brought down in the Branch Account is represented by the net assets of the branch, as follows:

	Unitas	£
Balance at Bank	366,400	3,664
Debtors	777,600	7,776
Stock	1,045,600	10,456
	2,189,600	21,896
Less Creditors	235,800	2,358
	U.1,953,800	£19,538

(2) The loss on exchange is credited to Branch Account and debited to the General Profit and Loss Account.

(3) It will be observed that all the items in the Trading Account are converted at the fixed rate of 80, so that the gross profit is not affected by exchange fluctuations. For the purpose of the Balance Sheet, however, the closing stock is converted at the rate prevailing at the date of the Balance Sheet, in the same way as the other current assets, and the Balance Sheet position is therefore not misrepresented.

Where it is the practice for the head office to invoice goods to the branch at a price in excess of cost, the debit to the Branch Trading Account in respect of such goods will include an element of profit for which credit has been taken in the Trading Account of the head office. In such a case, a Branch Stock Adjustment Account should be maintained in the head office books for the purpose of eliminating from the profit disclosed by the accounts the unrealised profit at which the branch stock at the date of the Balance Sheet has been brought into account. This may be done by debiting Profit and Loss Account and crediting the Branch Stock Adjustment Account with the profit loading included in the valuation of the branch stock, from which the amount of such provision will be deducted for Balance Sheet purposes. Where a provision for unrealised profit has been brought forward from the previous year, it will only be necessary, in the accounts for the current year, to make such an adjustment through the Profit and Loss Account as will be necessary to increase or reduce the balance on the Adjustment Account to the amount of the unrealised profit included in the closing stock of the branch.

Illustration (6)

B Ltd. has an authorised capital of £50,000 in shares of £1 each. It carries on a merchanting business at its head office in London and a branch in Australia.

All goods are purchased by the head office. Those for sale in Australia are invoiced to the branch at cost, including insurance and freight, plus 10 per cent.: the invoices are entered in the branch books when the goods are received there.

The branch books are kept in Australian currency, £A125 being taken as equal to £100 sterling.

The trial balances as on 31st December, 19 , are as follows:

	Head Office		Branch	
	Dr.	*Cr.*	*Dr.*	*Cr.*
Capital issued and fully paid:	£	£	£A	£A
40,000 shares of £1 each ..		40,000		
5 per cent. Mortgage Debentures		12,000		
Freehold warehouses at valuation	31,500		5,550	
Furniture and Fittings, at cost	6,300		2,250	
Depreciation of Furniture and Fittings		875		320
Debtors and unexpired payments	15,863		4,275	
Creditors and accrued expenses ..		17,471		225
General Reserve		16,000		
Profit and Loss Account – 1st January		2,153		
Debenture interest – net ..	345			
Carried forward ..	£54,008	£88,499	£A12,075	£A545

	Head Office		Branch	
	Dr.	*Cr.*	*Dr.*	*Cr*
	£	£	£A	£A
Brought Forward	54,008	88,499	12,075	545
Purchases	126,578			
Sales		130,251		55,093
Goods sent to branch ..		33,440	39,765	
Insurance and freight thereon	2,106			
General expenses	19,043		8,165	
Stock on 1st January ..	31,054		12,320	
Taxation Account		8,180		
Cash and bank balances ..	10,261		1,548	
Branch Account	18,216			
Head Office Account ..				18,235
Branch Stock Adjustment Account		896		
	£261,266	£261,266	£A73,873	£A73,873

You are given the following information:

(1) There were in transit on 31st December goods sent to branch invoiced at £1,628 and a draft from branch to head office for £A2,500.

(2) Stock valuations as on 31st December were: head office, at cost, £27,559 and branch, at invoiced prices, £A13,222.

(3) A case of goods received at the branch in December invoiced at £2,156, was recorded in the branch books and included in the Stock valuation, but when the case was opened it was found that the goods had been rendered valueless by damage at sea. Head office claimed for £1,960 (£1,870 for the cost of the goods and £90 for insurance and freight) from the insurers and this sum was agreed. No record of the damage or the claim had been made in the head office or branch books.

(4) Depreciation of furniture and fittings is to be provided for at 4 per cent. of cost.

(5) Interest on the debentures is payable half-yearly on 30th June and 31st December.

(6) Included in the head office General Expenses are directors' fees £1,500 and audit fee (fixed by the directors) £315.

(7) The manager of the branch is entitled to a commission of 10 per cent. of the profit shown by the Branch Profit and Loss Account after providing for that commission.

(8) To provide for United Kingdom taxation on profits to date, including £8,000 for future income tax, a credit balance of £19,000 is to be carried forward on Taxation Account. Australian taxation is to be ignored.

(9) The directors propose to transfer £2,000 to General Reserve and to pay a dividend of 25 per cent, less tax.

You are required to prepare:

(*a*) Trading and Profit and Loss Accounts in columnar form showing the net trading profit of the head office and the branch respectively for the year ended 31st December;

(*b*) The Company's Profit and Loss Account for the year ended 31st December and Balance Sheet as at that date, in a form suitable for presentation to the members.

TRADING AND PROFIT AND LOSS ACCOUNTS
FOR THE YEAR ENDED 31ST DECEMBER 19..

	London £	Australia £A		London £	Australia £A
To Stocks, 1st January	31,054	12,320	By Sales	130,251	55,093
Purchases..	124,708		„ Goods sent to Branch	31,284	
Goods from London		37,070	„ Stocks, 31st December	27,559	10,527
Gross Profit c/d.	33,332	16,230			
	£189,094	£65,620		£189,094	£65,620
To Insurance and Freight on goods to Branch ..	2,016		By Gross Profit	33,332	16,230
„ General Expenses .	17,228	8,165			
„ Depreciation	252	90			
„ Manager's Commission, 10% on £7,250		725			
„ Branch Stock Adjustment Account: Provision for unrealised profit	18				
„ Net Trading Profit for year	13,818	7,250			
	£33,332	£16,230		£33,332	£16,230

(b)

B LTD.
PROFIT AND LOSS ACCOUNT FOR YEAR ENDED 31ST DECEMBER

		£
PROFIT FOR YEAR, BEFORE TAXATION		17,203
After charging:		
Depreciation	324	
Debenture interest	600	
Directors' fees .	1,500	
Audit fee . .	315	
Deduct: UNITED KINGDOM TAXATION, based on profits for year		
Income tax .		10,565
PROFIT FOR YEAR AFTER TAXATION .		6,638
Add BALANCE BROUGHT FORWARD		2,153
AVAILABLE PROFIT		8,791
Deduct APPROPRIATIONS OF PROFIT:		
Transfer to General Reserve	2,000	
Dividend proposed, 25 per cent of £40,000, *less* tax at 8s 6d in £	5,750	7,750
BALANCE, CARRIED FORWARD		£1,041

B LTD.
BALANCE SHEET AS AT 31ST DECEMBER

	£	£		£	£
SHARE CAPITAL, in shares of £1 each:			FIXED ASSETS		
Authorised .	50,000		Freehold Warehouses at valuation		35,940
			Furniture and Fittings		
Issued and fully paid		40,000	Cost	8,100	
REVENUE RESERVES			Provision for depreciation	1,455	
General Reserve	18,000				6,645
Profit and Loss Account	1,041				42,585
		19,041			
			CURRENT ASSETS		
		59,041	Stocks in hand and in transit,	36,694	
FUTURE INCOME TAX		8,000	Debtors and prepayments	19,283	
			Insurance claim	1,960	
5 PER CENT. MORTGAGE DEBENTURES		12,000	Cash and Bank Balances	13,500	
					71,437
CURRENT LIABILITIES:					
Trade Creditors and Expenses	18,231				
Current Income Tax ..	11,000		} Directors		
Proposed Dividend (*less* tax)	5,750				
		34,981			
		£114,022			£114,022

Notes.

(1) No provision for depreciation has been made on the Freehold Warehouses.

(2) The assets and liabilities in Australia have been converted at the rate of £A125 to £100.

(1) The Current Accounts will appear as follows: *Workings.*

BRANCH ACCOUNT IN LONDON BOOKS

	£A	£		£A	£
To Balance b/f	22,770	18,216	By Goods in transit	2,035	1,628
			„ Cash in transit	2,500	2,000
			„ Adjusted Balance	18,235	14,588
	£22,770	£18,216		£22,770	£18,216
To Balance	18,235	14,588	By Damaged Goods returned	2,695	2,156
„ Profit and Loss Account Profit for year	7,250	5,800	„ Balance c/f. ..	22,790	18,232
	£25,485	£20,388		£25,485	£20,388

LONDON ACCOUNT IN BRANCH BOOKS

	£A		£A
To Damaged Goods returned	2,695	By Balance b/f.	18,235
„ Balance c/f	22,790	„ Profit and Loss Account Profit	7,250
	£25,485		£25,485

The closing balance is represented by net assets of the branch, incorporated in the company's Balance Sheet, as follows:

		£A		£
Freehold Warehouse		5,550		4,440
Furniture, etc.	£2,250		£1,800	
Less Depreciation	410		328	
		1,840		1,472
Debtors ..		4,275		3,420
Stocks ..		10,527		8,421
Cash ..		1,548		1,239
		23,740		18,992
Less Creditors	225			
Commission	725			
		950		760
		£22,790		£18,232

(2) In the London books the damaged goods are treated as returns from the branch, being credited to Branch Account and debited to Goods sent to Branch at the invoiced price, £2,156. The transfer to Trading Account in respect of Goods sent to the branch is thus £(33,440 — 2,156) = £31,284.

In regard to the insurance claim, the Insurance company is debited with the £1,960, Purchases being credited with the cost price of the goods, £1,870, and Insurance and Freight Account with £90. The charges to Trading and Profit and Loss Account are accordingly reduced by these amounts.

(3) The closing stock of the branch is reduced by the invoiced price of the damaged goods, *viz.*, £2,156 $\times \frac{125}{100}$ = £A2,695.

(4) General Expenses charged in the head office Profit and Loss Account are reduced by the directors, and audit fees, which are charged in the general Profit and Loss Account of the company.

(5) The profit for the year, before taxation, shown in the Profit and Loss Account is made up of:

			£
London Trading Profit ..		..	13,818
Australia Trading Profit $\frac{100}{125}$	£7,250	..	5,800
			19,618
Less Debenture Interest		£600	
Directors' Fees		1,500	
Audit Fee .		315	
			2,415
			£17,203

(6) The charge to Profit and Loss Account in respect of the provision for unrealised profit is computed as follows:

Branch Stock, £A10,527 $\frac{100}{125}$	..	£8,421	
Goods in transit ..	..	1,628	
	$\frac{10}{110}$	£10,049	£914
Less Provision brought forward	..		896
			£18

(7) Creditors and accrued expenses:

London	..	£17,471
Australia (as in (1) above)..	..	760
		£18,231

(8) Stocks:

London	..	£27,559
Australia (as in (6) above)	.	8,421
Goods in transit ..	.	1,628
		37,608
Less Unrealised profit	.	914
		£36,694

MECHANISED ACCOUNTING

§ 1. Principles

The aims and limitations of mechanised systems of accounting are well described in the following extract from the Report of the Mechanised Accounting Sub-Committee of the Taxation and Financial Relations Committee of the Institute of Chartered Accountants.

The use of machines for accounting is not different in principle from the use of machines in a factory. The objects are to reduce the man-power required and time taken for a given process and to reduce the possibility of error; in other words, to increase efficiency. To achieve these objects machines tended by trained operators are used to carry out work which would otherwise require manual labour and mental exertion. Specialisation of function is developed extensively and emphasis is transferred from the skill of individual book-keepers to the control exercised over the feeding of material to machines and over their output. Ultimately, the purpose of accounting is to present information for the benefit of interested persons whether shareholders, directors, managers or others – and for this purpose the personal skill of the accountant is essential. Mechanisation can be applied only to the accounting processes involved in preparing the material from which the final information can be presented. Accounting skill and effective control are vital.

In deciding whether or not to mechanise it is necessary to consider what are the products of the existing system, in the form of accounting documents and records for internal and external use, and to ask the following questions:

(*a*) Are those products actually used or necessary and, if so, do they satisfactorily fulfil their purpose?

(*b*) Would other documents and information be of value and, if so, could they be obtained from the existing system?

(*c*) Is the existing system capable of producing the essential records and documents at the time when they are required and at reasonable cost?

(*d*) What are the possibilities of material variations in the load on the existing system and will that system enable substantial expansion of activity to be dealt with?

If the answers to those questions are satisfactory, further consideration of mechanisation is unlikely to serve any useful purpose. If the answers indicate that an improvement may be possible it is then necessary to analyse the accounting operations of the business and to consider whether mechanisation could effect the improvement.

Accounting operations comprise four main processes carried out within a framework of accepted principles:

(*a*) Recording transactions (for example, cash receipts and payments, purchases and sales).

(*b*) Adding and calculating.

(*c*) Sorting or analysing, including ledger posting.

(*d*) Reproducing records (for example, copying of documents, preparation of sales ledger statements, trial balance).

Machines are capable of carrying out all these processes, but it is not necessarily advantageous to use machines in all cases because, *inter alia*, it may not be possible to utilise time

saved on manual operations in other profitable ways. Where the number of transactions is small, or where there are few entries of uniform type, mechanisation to any great extent is generally unsuitable. Mechanisation depends for its success on the grouping of transactions so that each group contains a large number of transactions requiring similar entries. Given a sufficiently large number of entries of uniform type, accounting processes can be mechanised extensively. Each process should be examined and divided into its component operations, involving a review of peak loads and the collation of different operations which may consist in part of similar accounting processes. Care is necessary to distinguish between transactions that are genuinely identical and those that are only superficially so, and it should be borne in mind that abnormal items must usually be treated separately, probably by manual methods.

From an examination in the foregoing manner it will be possible to decide whether or not mechanisation would be beneficial. Frequently it is found that whilst mechanisation would be helpful in certain directions, it is unnecessary or even undesirable in others and an endeavour must be made to weigh impartially the advantages and disadvantages. Moreover, machines may be introduced for special purposes only, or for general convenience, without causing any major change in the accounting system. Examples of 'special purpose' machines are cash registers for use in shops, postal franking machines, cheque-writing machines, time-recording clocks (attendance and job) for use in connection with the payment and analysis of wages. Examples of 'general convenience' machines are calculating, adding and listing machines, some of which require trained operators while others can be operated easily without special training. Even in the smallest of businesses the use of one (or more) 'general' or 'special purposes' machine(s) has come to be regarded almost as a normal part of the clerical arrangements.

In a limited sense mechanised accounting means the use of machines designed to carry out the routine processes of double-entry book-keeping. Of such processes those most amenable to mechanisation are the posting and balancing of the personal ledgers, the writing up of cash received and cash paid books coincidently with the preparation of official receipt forms and the drawing of cheques respectively, and the analysis and tabulation of data.

The work of the book-keeper is, however, dependent upon many subsidiary processes which, in many cases, are carried out in the same office and to a certain extent (and subject to the limitations imposed by an adequate system of internal check) by the same clerks. These auxiliary processes include the preparation of advice notes and invoices for goods sold, the checking of invoices for goods and services purchased, the preparation of pay rolls (including the necessary P.A.Y.E. calculations) the maintenance of stock records, the evaluation of stock inventories and many others which are all susceptible to mechanisation in some degree. In the fullest sense, therefore, the study of mechanised accounting includes a consideration of many different office machines and appliances.

§ 2. Writing and Copying Devices

In modern offices the use of the typewriter extends far beyond its original purpose of writing letters. The following developments and improvements of the original form of typewriter afford examples of the mechanisation of office routines:

(*a*) The use of *continuous or 'fan-fold' stationery* in a machine adapted for the purpose facilitates such repetitive processes as invoicing. Much the same result is achieved by the use of forms fastened together in sets. A set of forms designed for invoicing might comprise the following:

(i) Invoice (Top copy, with suitable printed heading).

(ii) Customer's advice or delivery note. (First carbon copy also with suitable printed heading.)

(iii) Warehouse advice note. (The second and subsequent carbon copies are flimsies on which a minimum of printed matter appears.)

(iv) Posting slips.

(v) Sales office copy (this may also constitute a form of sales day book.)

Each form in a set bears the same serial number as its fellows. The use of different coloured paper helps to distinguish the various parts of the set and facilitates their subsequent distribution to the departments concerned.

(*b*) *Carbon smearing* ('carback') on the back of all forms except the last of a set, makes the use of loose carbon papers unnecessary. This facilitates selective copying, as it is not always necessary to reproduce all the original data on every copy. For example, advice notes prepared as copies of invoices may omit the price of the goods and the amount of the invoices, dealing only with the quantity and description of the goods to be delivered.

The method also results in a substantial saving of operator's time that would otherwise be occupied by inserting and removing loose carbon papers. As an alternative to the use of carbacked forms chemically treated paper is obtainable, such as N.C.R. (No Carbon Required) paper, which provides a copy of handwriting or typescript when brought under pressure.

(*c*) *Stencil copying*. When more than a relatively small number of copies of an original document are required the typewriter may be used either to cut a stencil or plate or to back the original with a chemical negative from which copies may be run off on a spirit duplicator. The latter machine may be used to prepare copies of accounts and forms when the numbers required are not such as to justify the cost of orthodox printing.

(*d*) *Photocopying*. The problem of storage space in offices handling a large volume of records has led to the practice of making and storing microfilm copies of all original documents. This is capable of being applied with equal facility to documents received from outside sources (*e.g.* suppliers' invoices) as to internal ones (*e.g.* sales invoices). Carbon or other copies of documents produced in the office will be prepared in the usual way but can be destroyed after they have fulfilled their normal functions of providing posting media, etc.

(*e*) '*Collating Carriage*' typewriters are provided with a 'front-feed' in addition to the normal means of inserting forms at the rear of the roller platen. This enables one form or set of forms to be retained in the machine and thus to record a series of transactions while other forms are inserted before and withdrawn after each single

entry. With the addition of suitable adding mechanism such a typewriter becomes a book-keeping machine; without this facility it can nevertheless be used for many subsidiary book-keeping processes, *e.g.*, receipt writing combined with the preparation of a cash received sheet, cheque writing combined with the preparation of a cash paid sheet, etc.

The application of such a method to the recording of cash receipts produces at one operation four distinct records, as follows:

(i) *Receipts.* These are printed either in sheets of 20 or more or as a continuous roll or fan-fold. As part of the system of internal check, the serial numbers are printed on the receipts but are typed on the control sheet (cash received book) by the operator.

(ii) *Posting Slip.* This, like the receipt form, is perforated between each entry so that the slips can be sorted into account order and distributed to the various ledger keepers.

(iii) *Cash Received Book.* This is the 'control sheet' since it receives the full record. The entries here are in single spacing, although on the receipt forms they are about 1 inch apart. Each receipt and posting slip may be detached after completion but the control sheet remains in the machine and is spaced up to receive the next entry.

(iv) *Bank Pay In-Advice.* This is used only where the customers pay by cheque, as in a wholesale house. Where there are also many cash items for which receipts have to be given, they will preferably be dealt with separately, possibly by a form of cash register.

If the machine is fitted with suitable 'adding boxes' or incorporates sufficient registers, the 'amount' and 'discount' columns in the cash received book will be totalled automatically.

A book-keeping machine that is provided with a typewriter keyboard may be used for receipt-writing or cheque-writing and on the more comprehensive accounting machines these functions may be combined with ledger posting. Thus two more documents are added to the list of those created; these are a ledger account (perhaps together with a statement or remittance advice) and also a ledger posting summary. The ledger card is set up beside the receipt (or cheque) and collated stationery, and the figures are transferred mechanically across to the ledger card. This automatically ensures agreement between the amount shown in the cash book and the amount posted to the ledger. The posting slip, that would otherwise have been produced as a carbon copy of the receipt or cheque, is then unnecessary.

(*f*) '*Split Platen*' typewriters and accounting machines enable two forms to be inserted side by side in the machine so that they can be spaced up either independently or in unison. This is not to be confused with the front feed or collating carriage; in certain types of apparatus the two features are found in the same machine.

'*Peg Board*' methods enable many of the principles of mechanised accounting to be applied manually. The peg board is a comparatively simple device which enables forms to be superimposed on each other in the position required by the operator and to retain their relative positions while each entry is made. The method may be explained in relation to a process for which it has proved particularly suitable – the preparation of pay sheets and income tax (P.A.Y.E.) records:

Three forms are normally used:

(i) Employee's personal record which, by arrangement with the Inland Revenue is an approved alternative to the tax deduction card normally used. Each sheet contains a complete record for one fiscal year of the pay and tax deductions of the employee to whom it relates.

(ii) Pay roll, recording the pay and tax deductions of all employees for one week.

(iii) A carbon copy of the pay roll perforated between each line of entries so that the details applicable to each individual employee can be detached and inserted in his pay packet for that week.

(ii) and (iii), interleaved with carbon paper, are placed on the board and remain in the same position until the whole page or the entries for the week have been completed. The personal record (i) for the first employee on the pay roll is then placed over (ii) so that the spaces in which the entry is to be made come into alignment A sheet of carbon paper has, of course, previously been inserted between (i) and (ii). After the appropriate entry has been made, this personal record sheet is removed and the next one inserted one space lower on the board, the tax calculations and entry for the second employee are completed, and so on.

The advantages of such a method are not restricted to time saving. Errors that might be involved in the normal process of entering gross wages on tax deduction cards and then transferring the tax deduction back to the pay roll are eliminated. Automatic agreement of the tax deduction for the year as shown by the individual records and in the financial books should be secured.

Further examples of the mechanisation of those processes which involve writing or some similar record are:

(1) *Cheque writing machines*, which by the use of special pin-point type and/or acid proof ribbons cause the wording to be impregnated into the body of the paper on which the cheque form is printed. An unauthorised alteration of a cheque already drawn is thus made impossible.

The system of internal check must be such that the stock of unused cheque forms is in responsible custody and the use of the machine is strictly controlled.

(2) *Cheque signing machines* which enable a facsimile signature or signatures to be applied to batches of cheques and other documents. A very strict system of control is of course essential and the bank on which the cheques are drawn will normally require an indemnity against losses arising from the unauthorised use of such a device.

It may be possible to provide for the paying bank to be given lists of all the cheques signed in this way before they are issued, so that they can be checked by the bank against such lists before they are paid.

(3) *Addressing machines* designed primarily to facilitate the rapid addressing of correspondence, circulars, etc., (and providing at the same time a convenient permanent record of names and addresses) but having uses that go far beyond that original purpose. The data are recorded on a stencil or metal plate of convenient size and the stencils thus prepared provide a form of 'card index'. In company share registration work where this system is used, the stencils will provide the master record of shareholders' names and addresses; on receipt of a notice of change of address the old stencil is withdrawn and a new one prepared. They can be used for writing up the first column of dividend lists, as a basis for the annual return, for inserting names and addresses in the two parts of dividend warrants and for many other purposes in addition to the routine task of addressing envelopes either to individual members or to the shareholders (or one class of them) as a whole.

§ 3. Adding and Calculating Machines

Machines which add or subtract figures, giving a result which can be read from the machine but do not produce a permanent record of the amounts or the result constitute the first type of adding machine to be considered.

These machines normally have a full keyboard, as illustrated on page 446, and the result appears in a row of small 'windows' at the foot of the machine. The simplest models have no operating keys other than the number keys shown in the diagram plus a lever for 'clearing' the machine at the end of each operation. The depression of a key or a group of keys operates the mechanism directly and the result (*i.e.*, the sum of all the numbers or amounts recorded since the machine was last cleared) appears at once in the windows.

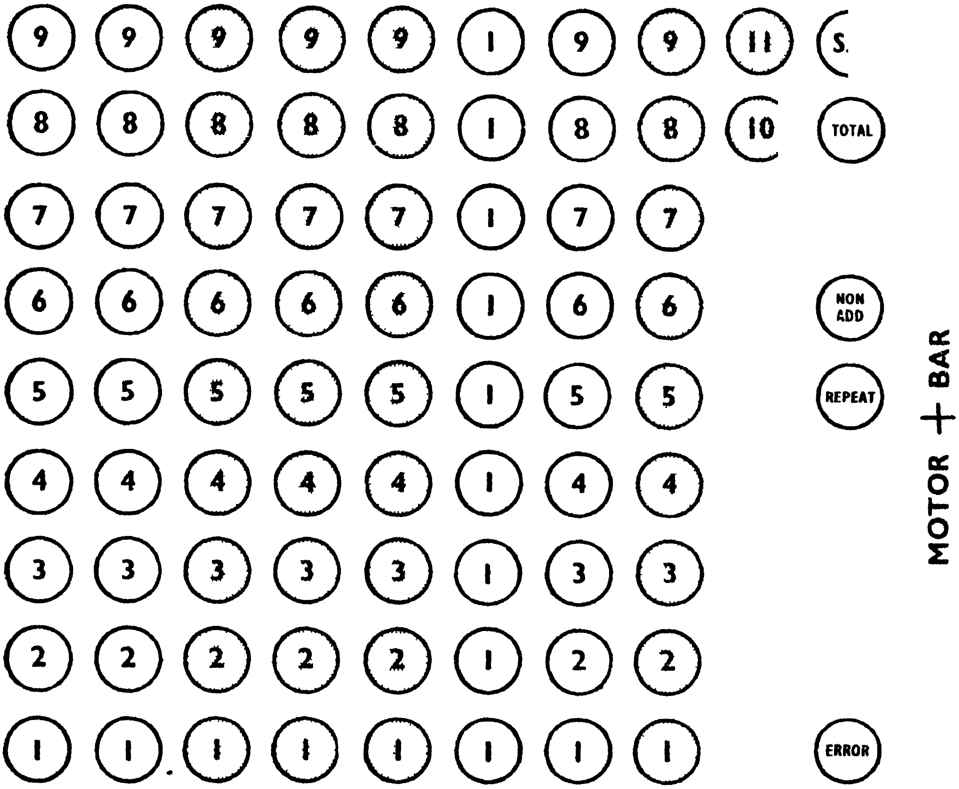
With such a machine subtraction has to be effected by adding the 'complement' of the number to be subtracted, this being the difference between 9 for each digit and the number itself. Thus the subtraction of 231 from 698 is obtained, in effect, by adding 768 (*i.e.*, 999 — 231) to 698. The result (1,466) given by the machine has to be corrected by discarding the first digit, 1, and adding 1 to the final digit, giving the correct result, 467.

Other machines may be provided with several operating keys in addition to the number keys as shown in the diagram. With these a number is first 'set up' by depressing the number keys and is then added to the existing total by pulling a lever in a hand operated machine or depressing a motor bar in one provided with an electric motor. With such machines direct subtraction is usually possible, a 'subtract' operating key being provided.

Illustration (1)

The number and position of the operating keys vary according to the make and purpose of the machine. The keyboard illustrated here is suitable for an adding-listing machine.

FORM OF FULL KEYBOARD



Adding machines with a full keyboard (and particularly those with a direct action, such as the Comptometer) can be used for multiplication and division by the process of repeated addition or subtraction, as explained below.

Half Keyboard Machines

A type of adding machine that is becoming increasingly used in auditing practice because of its lightness and compactness (it fits into a very small attaché case) has a keyboard on which five rows of numbers appear instead of nine, the highest digit being 5 (with a 6 in the pence column). Amounts containing higher digits than 5 are obtained by successive depression of the appropriate keys (*e.g.*, 7 by recording 4 and then 3, and so on).

Adding-Listing Machines

For many office routines a machine which produces a typewritten record (usually on a roll of paper which can be torn off at the conclusion of each operation) is much more useful than a simple adding machine. Such a machine normally records amounts only, but sometimes has a 'split keyboard' which, in combination with a 'non-add' control enables, say, the first three columns of figures to be recorded as reference numbers, which are not added, while the remaining columns deal with the amounts in

the usual way. The machine may also have a platen, like a typewriter, so that forms can be inserted instead of the roll of machine 'tape'.

The action of an adding-listing machine is always two-fold, *i.e.*, the amount is first set up on the number keys and the depression of a separate operating key or handle then causes the amount to be typed and to be added to the total already recorded in the mechanism. (In some modern machines the use of a separate operating key is made unnecessary by what is known as the 'live keyboard' feature. Every key on the number keyboard has two pressures; the amount is set up in the normal way on the first pressure but the second pressure is exerted on the last key to be set up, and this causes the whole amount to be added.) The result of the addition, however, is not visible at this stage but is obtained when required by depressing a total or a sub-total key. In the first case (total key) the total is typed at the foot of the column and is then cleared from the machine. In the second case (sub-total key) the total is printed but remains in the machine and will be included in some subsequent total or sub-total. To avoid confusion different symbols are printed automatically against each total or sub-total. Even so it is always advisable to commence a new list by depressing the total key. Assuming that the machine has been properly cleared at the end of the previous operation a 0 followed by the 'Total' symbol will be printed. This precaution is unnecessary if, as is becoming more usual, the machine is equipped with a 'clear' symbol to indicate that it was empty when the first item was entered. This symbol appears against the first item to be listed following the totalling and clearing of the previous list.

Adding-listing machines are particularly useful for the operation of 'pre-listing' which is an essential part of mechanised ledger posting systems (*q.v.*).

Twelve-Key Keyboard

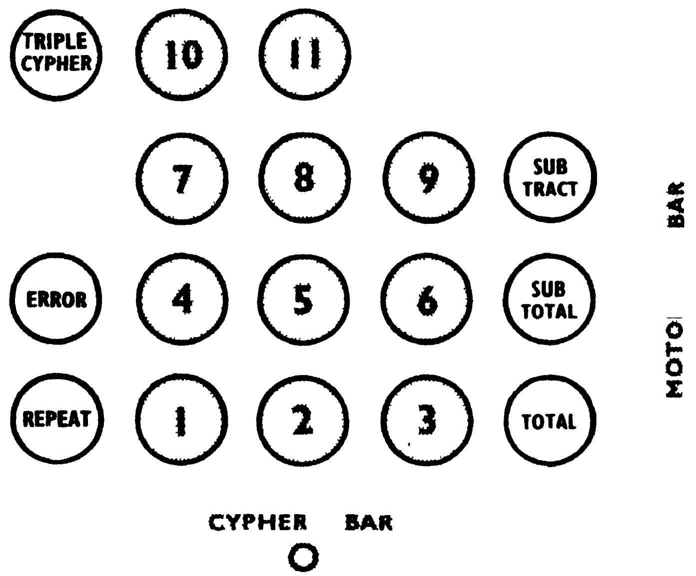
Although many adding-listing machines have the full keyboard, the fact that an amount has to be set up before the actual operation is effected has made possible the twelve-key keyboard shown in the following illustration.

Illustration (2)

The keys appropriate to a number are depressed in their natural order, *e.g.*, to set up £1,023 6s. 7d. the keys 1, 0, 2, 3, 0, 6, 7, are depressed in that order. It will be observed that where the number of shillings is below 10, the cipher (0) key has to be used in the ten shillings position; if the keys 1, 0, 2, 3, 6, 7 had been pressed the result would have appeared as £102 16s. 7d. (in the antepenultimate position any key other than 0 records as 1). Depression of the + bar on an electric model or the pulling of a handle on a manual machine will cause the amount to be typed and recorded in the adding mechanism. The next amount set up will be typed and either added to or deducted from the existing total according to whether the + or — key is depressed. In fact, apart from the routine of setting up an amount, the operation of the machine is similar to that of the full keyboard type.

Other operating keys, in addition to + and — provide either a total or a sub-total; 'non-add' (*e.g.*, an amount is typed but not added to the existing total, which remains

FORM OF TWELVE-KEY KEYBOARD



undisturbed); 'whole number' which cuts out the shillings and pence and which in conjunction with the non-add mechanism also enables reference numbers to be recorded; and 'correction' which enables a number which is known to have been wrongly set up to be deleted before the adding mechanism is operated. Where an error is discovered after an amount has been added in it can only be corrected by subtracting the same wrong amount or by clearing the machine and starting again.

A disadvantage of this keyboard as compared with the full keyboard is the fact that all ciphers have to be recorded, whereas on a full keyboard model they are ignored. It has the advantage of compactness and an unskilled operator can use it with ease and speed.

Duplex Machines

A machine with two distinct adding mechanisms or 'registers' is known as a duplex machine. It has many advantages as compared with a simplex or single register machines. For example, a simple analysis may be made of amounts under two headings, with their respective totals or amounts which commonly go in pairs, such as cash and discount or goods and purchase tax, may be listed in two columns at the same operation. Alternatively, by automatic transfer of totals from one register to the other, the machine may be used to list items in a number of different batches and to give a grand total automatically.

Splits

As an alternative (or in addition) to the provision of two or more distinct adding mechanisms, it may be possible to 'split' one mechanism into two or more sections.

Most adding machines have a capacity far in excess of the amounts normally listed on them, *e.g.*, the capacity of a machine may be £9,999,999 19s. 11d. in the amount keys, with one or two additional columns in the 'total' register, whereas the amounts listed may rarely exceed £100. It is possible by a 'split' mechanism (which may be either fixed or variable) to secure that, say, the four left hand columns do not receive any carry over from the columns to their right. The left hand group of figures may then be used to record a reference number or quantity while the remaining columns to the right of the split deal with the amounts in the usual way.

A 'cipher split' has the effect of eliminating all 0's from the shillings and pence columns, except where an amount of 10s. is involved. This enables the 'pounds' columns of the machine to be used for listing and adding whole numbers.

When the adding mechanism is incorporated in an accounting machine the process of splitting may be varied according to the position of the carriage of the machine at any given time. In some columns the machine will then record whole numbers only and in others full amounts in pounds, shillings and pence. The mechanical device which secures this result is known as hammer blocking.

Calculating Machines

Calculating machines fall into two main groups, the full keyboard type and the barrel type.

A *full keyboard* machine is an adding machine of the direct operation type (*e.g.*, Comptometer) on which a group of keys constituting a number (or amount) can be depressed rapidly from one to nine times, according to the mutliplier. Movement of the operator's fingers from left to right or *vice versa* reflects, as it were, the positions of the decimal point in relation to the various digits in the multiples (1234 multiplied by 56 being the same as 12340 multipled by 5 plus 1234 multiplied by 6). Division is similarly effected by a process of repeated subtraction. For satisfactory results the services of a highly trained operator are required; given this, all ordinary commercial calculations can be carried out with extreme speed and accuracy.

Machines of the *barrel type* also operate by successive addition (which is, of course, the basis of all multiplication), but this is effected in a different way. In the first place the multiplicand is set up in the machine by moving levers or depressing number keys, which causes a row of cogs to emerge to a greater or less degree from a cylinder. This mechanism is, of course, under cover and cannot be seen during the ordinary operation of a machine; a brief account of the mechanism is necessary, however, to explain the method.

The cylinder can be rotated either by turning a handle or by depressing one of a second set of number keys which causes an electric motor to rotate it the required number of times. At each rotation the cogs that have emerged from the cylinder engage with the teeth of what is, in effect, an ordinary row of adding wheels which can be observed through the result windows of the machine. This part of the mechanism slides from left to right according to the position in the multiplier of whatever digit is being dealt with. Thus to multiply 7654 by 32, the multiplicand 7654 is first

set up on the machine, the barrel is rotated twice in the units position and the slide is then moved one place to the right before the barrel is again rotated three times.

Rotation in the reverse direction subtracts. Decimalisation is essential; the machine cannot set up or cope with shillings and pence.

The number of turns of the barrel in successive positions of the slide is recorded in a further row of dials which for multiplication show the number of positive turns but for division can be altered to record positively the number of negative turns. Thus at any given time the machine shows, in relation to multiplication:

(i) The multiplicand that was set up in the machine;

(ii) The multiplier (*i.e.*, the number of rotations of the barrel);

(iii) The result:

and in relation to division:

(i) The dividend that was set up in the machine;

(ii) The divider (*i.e.*, the number of negative or subtractive rotations of the barrel);

(iii) The result.

All these dials must be cleared before the next operation is commenced, unless the multiplicand (or dividend) is common to more than one set of products, when it is possible to pass from one multiplier to the next without clearing.

For example, suppose it is desired to calculate a dividend of 21¼ % on holdings of 125, 140, 150 and 175 shares. 21¼ per cent. is expressed as a decimal ·2125 and set up as the multiplicand. The first result is obtained by multiplying by 125. Without clearing the machine, five additional turns in the units position plus one in the tens position show the result for 140 shares; one more turn in the tens position converts this into 150 and so on. For repetitive calculations of this sort or for calculations involving large numbers (the capacity is often 999,999,999 × 999,999,999) these machines are unrivalled.

§ 4. Ledger Posting Machines

Machines of this kind usually combine some of the characteristics of typewriters and adding machines. In early models an ordinary type-writing mechanism was provided with 'adding boxes' which added or subtracted amounts as they were typed. The operator had to read the result from the dials of the adding box and type it on to the form or account. Modern machines perform the mathematical processes, tabulate to the correct positions for the successive operations and type the results (*i.e.*, the new balances on the accounts) automatically. They also provide a control sheet or record of all the postings in a batch and total and 'prove' this automatically.

Where a full typewriter keyboard is provided the figuring is usually done by a row of number keys (one for each digit) operating in the same way as the twelve figure keyboard. Alternatively a full number keyboard may be provided in conjunction with a limited number of keys which use a few standard abbreviations such as CSH, DIS, GDS to record the narration. Some machines have full keyboard and typewriter.

Any form of mechanical ledger posting is based on the principle of the 'slip system', *i.e.*, the ledger is 'posted' from the original documents or copies (posting slips) while the control sheet, which is a carbon copy of the whole of a batch of postings, takes the place of the day book and provides the necessary totals for completing Control Accounts and impersonal ledger postings. Where two copies of the ledger account are made one serves the purpose of a monthly statement (sales ledger) or payment advice note (bought ledger). Different machines and systems vary in some respects, but the following may be regarded as typical.

A machine posted ledger differs from the orthodox form of handwritten ledger in that it shows the balance on each account after each posting (or batch of postings to the same account on the same occasion). The first operation, therefore, is the 'picking up' of the existing balance; the amount being posted is then added or, where appropriate, subtracted.

In the case of a sales ledger, the existing balance is normally a debit balance, which is increased by debit postings for goods sold and reduced by credit postings for cash received and discount allowed. An adding mechanism, known as a 'crossfooter' receives the amount of the 'pick up' (*i.e.*, the old balance) adds to it any amount now recorded in the debit column, deducts from it any credit posting, and causes the result to be recorded in the balance column, where it represents the new balance of the account. A special routine may be necessary to pick up old 'credit balances' on a Sales Ledger Account.

It must be borne in mind that the terms 'debit' and 'credit' have no meaning, in themselves, in relation to adding mechanism; amounts are either positive or negative, and are added or subtracted accordingly. A Bought Ledger Account normally has a credit balance to which credit postings have to be added while debit postings are, in this case, negative. Where the same machine is used for bought and sales ledger postings it is often found, therefore, that the bought ledger cards are printed in reverse, in the following form:

Date	Narrative	Credit	Debit	Balance

This avoids frequent alteration of the set up of the machine.

Sources of Error

So far from eliminating all possibility of error, a machine system may introduce some new ones (*e.g.*, in the pick up of the existing balance, which does not arise when ledgers are posted by hand). Any well designed system, however, is provided with a number of checks, which enable errors to be detected and rectified almost as soon as they have been made, and the reduction in the physical and mental burden of writing and

arithmetic reduces the chances of errors being made. The following are the more important sources of error and the steps which should be taken to prevent or detect them.

(1) The operator may select the wrong ledger card and then post to the wrong account. This risk can be minimised by:

(*a*) Sorting the posting media into account order before a batch of postings is commenced and either 'stuffing' them into the appropriate places in the racks of cards or 'pulling' all the cards required in advance.

(*b*) Providing suitable racks or trays which facilitate the handling and selection of the ledger cards.

(*c*) By giving each account a number, which is made part of the typed record of each posting. If the wrong card is used a 'wrong number' will show up in the account number column of the ledger card. The operator must, of course, be trained to type the account number from the posting medium and not from the card itself unless the machine is of the type in which the card, after insertion, is not visible to the operator.

It may be noted that unless the account name (only possible with full typewriter keyboard machines) or number is made an integral part of each posting, the control sheet will only constitute an imperfect day book, for the amounts appearing on it will not be identified with the accounts to which they relate.

(2) The existing balance may be picked up incorrectly, giving rise to a corresponding error in the amount of the new balance.

Different systems overcome this in different ways but most depend on the 'double pick up', *i.e.*, after the posting has been completed, but before the card is withdrawn from the machine, the old balance is picked up again. In some systems the machine has two crossfooters, one of which receives the first pick up and the other the second (as a negative amount); the other operations (*i.e.*, the postings themselves) are received by both, but one records negatively what the other records postively and *vice versa*. Thus, provided the same old balance was picked up on each occasion, the new balances recorded by the two crossfooters will be equal in amount but opposite in sign. In the clearing of the machine when the card is withdrawn the one balance is added into the other, cancelling it and causing a 'O' (or 'OT') to be printed on the control sheet; this is therefore known as the 'cipher proof'. If the two pick ups were not of the same amount the final balances would differ and some amount other than 'O' would be printed. Of course, if the operator were to take the second pick up from the entry just made for the 'old balance' there would be a compensating error and the check would be valueless. It is therefore, usual to find that the record of the first pick up is not visible when the second pick up is made, and whereas the first pick up comes at the beginning of the sequence, the second is made to come at the end.

(3) The amount to be posted (say of a sales invoice) may be copied incorrectly from the posting medium.

This is detected by the process of 'pre-listing' – *i.e.*, the amounts only of the batch of posting media are run off and totalled independently on an adding-listing machine. The system of internal check is strengthened if the pre-list is prepared by someone other than the ledger posting machine operator.

In addition to the crossfooter the machine may be provided with one or more 'registers' each of which totals all the amounts entered in one particular column of the control sheet. When the invoices have been posted the total of the sales ledger debit column postings can be compared with the pre-list and unless compensating errors have been made an error in posting will be revealed.

Control Accounts

An overall check on the accuracy of the ledger postings is obtained by maintaining Control Accounts which follow the ordinary principles of self-balancing ledgers. The control sheet totals for each batch of postings provide the amounts to be posted to the Control Accounts.

Where large numbers of accounts are concerned they should be controlled sectionally; otherwise the time spent in looking for a difference may outweigh the advantage of keeping Control Accounts.

It must be remembered that while each control sheet shows the new balance on the accounts affected by that batch of postings it does not give a complete list of all balances on accounts in that ledger or section. The ledgers are therefore 'balanced' against the Control Account by running out the balances on an adding-listing machine. This cannot usually be done more than once a month so that a Control Account does *not* provide a day by day check on the accuracy of the entries.

Double Run

Instead of taking a carbon copy of the ledger card as a statement (or *vice versa*), the statement can be prepared independently by a second operator using the same posting media. This strengthens the system of internal check and is much used by banks for preparing customers' statements (which are not then carbon copies of the ledger accounts but independently produced records). With such a system the double pick up of old balances and the pre-listing of posting media become unnecessary, and an effective check against posting to the wrong account is obtained.

§ 5. Punched Card Systems

Accounting machines can be divided broadly into two main categories, firstly, there is that group comprising machines which are usually key-operated and which simulate the manual book-keeping processes but relieve the operator of the mental arithmetic, and secondly, there is the punched card group. In the latter class the basic data is first recorded in the form of perforations in cards which, subsequently, are manipulated entirely mechanically and automatically.

In punched card systems one card is normally used to record the basic data relating to one transaction and it is the location of the perforations that gives them a corresponding numerical or alphabetical significance.

The cards can be mechanically sorted into any desired grouping and subsequently passed through a tabulator which 'reads' the perforations and prints the information on to the usual accounting forms, invoices, statements, ledger sheets, etc. Addition or subtraction can be carried out simultaneously with the printing operation.

The great advantage of the punched card technique is that once the card is punched and verified an accurate and unalterable record is established from which any accounting or statistical statement can be rapidly obtained mechanically. The automatic machines used for processing the punched cards eliminate the human element almost entirely and function at very high speeds.

There are three main systems now in use in this country and these are generally known under the names of the manufacturers B.T.M. (Hollerith), I.B.M., and Power-Samas. The first two makes concentrate largely on one size range of machines, whereas, Power-Samas make several sizes some of which are mainly mechanical but others use electrical and electronic principles.

The Cards

The recording capacity of the cards is expressed in columns and the 'standard' size card (7·325″ × 3·25″) is capable of holding 80 columns of information. From top to bottom each column – on each card – has twelve punching positions. They are usually designated A, B, C, 1, 2, 3, 4, 5, 6, 7, 8 and 9, and can be used singly to record twelve base numbers such as the months of the year or 0–11 pence.

Alternatively, the 1–9 positions are used to record 10 base numbers (it is not essential to punch zeros in some systems) and the upper A, B, C, positions can be allocated values of 10, 20 or 30, so in conjunction with a lower hole any value from 1 to 39 can be accommodated in one column. The days of the month are frequently recorded in this manner.

Perforations to represent the letters of the alphabet and special signs are made in the same way, Z for example (the 26th letter), being punched as a combination of the B and 6 positions.

Cards known as 'dual purpose' cards are frequently used as original documents (stores requisitions for example). They are first written out and later the same information is punched in the same card form.

Punching the Cards

Perforating the cards to correspond with the original data is accomplished in a variety of machines which are described in later paragraphs, but it is simpler first to describe the one machine which is essential in most installations but which is used to a lesser degree in those which are highly mechanised. This is the Universal Automatic Key Punch, which is operated much in the same way as a typewriter but it punches holes instead of writing characters. Also, it is power-driven and this enables the operator to repeat such items as the date into any number of cards.

There is also a manually driven Hand Punch but this is only used for very short runs or for making corrections.

The punching of cards by means of these machines is the only operation in the entire system which is dependent on manual dexterity. It is, however, extremely rapid and provided the information is presented in suitable form and order, can be faster than any other means of original recording. It is customary therefore to have such items as account number, commodity number, etc., already coded and recorded on the original document ready for the Punch operator.

Verifying

Since the original cards will be used to produce mechanically all subsequent records it is essential for the accuracy of the initial punching to be ensured. There are several ways of achieving this, but for checking original punching the usual principle that two operators will not repeat the same mistake is followed.

In the Power-Samas system the first punching produces round holes. A second passage through the punching machine with a control lever set to 'verify' causes the original holes to be 'ovalised' if the second operator depresses the same keys as the first. If there are any differences in the two sets of depressions some round holes will remain.

The batch of cards is then passed through an Automatic Verifier which detects cards with errors and inserts a signal card to indicate their location so that they can be easily extracted and corrected.

There is also a Hand Verifier, a very simple machine, which locks if the key depressions made by a second operator do not correspond with the holes made by the first. Such machines are only used for small quantities of work.

Sorting

Having been punched and verified the cards form a medium which can be processed physically rather than by the mental processes usually associated with book-keeping. They can be mechanically sorted and re-grouped as often as may be required and it is this facility of automatic sorting that provides the great advantage of punched card systems.

Thus after tabulating invoices when the cards may be in no particular order, they can be sorted at speeds of up to 60,000 per hour, into say, Commodity order or Salesman's order for the preparation of statistics.

Sorting is done column by column, so if account numbers run to four digits (9999) it is necessary to run the cards through the machine four times. In each run, the machine groups all cards with a common number in the column being sorted and at the same time puts all groups into numerical sequence.

Tabulating

After the punched cards have been sorted into the required sequence and grouping they are ready for the third (and usually, final) operation known as 'tabulating', a term which covers the mechanical production of the various accounting records from the punched cards.

The cards are fed into the Tabulator, which automatically senses the perforations in the cards and prints, in normal characters, all the information punched in each card

on continuous forms, loose leaf sheets or, in fact, any orthodox business stationery. Simultaneously the Tabulator accumulates quantities and amounts (both debit and credit) and automatically prints totals and balances where required.

The punching in all the columns of each card is sensed simultaneously and one complete line of type representing all the information punched in a card is printed at one stroke as compared with the step by step methods of manual or other machine methods.

In the Power-Samas system the wide flexibility of application of the Tabulator is achieved by the 'Connection Box' which controls the location of the printed result in relation to the perforations in the cards. By means of the Connection Box the order in which the printed information appears may be varied from the sequence in which it is punched; for example, the information punched in column 1 of the card may be printed in, say, column 4 of the tabulation. In some installations a number of different tabulations, such as invoices, statements or payroll may be produced with one Connection Box; in others there may be several. In any case the boxes provide a means of changing the set up of the tabulator which can be carried out in a few seconds and which cannot be done incorrectly.

Ancillary Machines

The machines already described, *i.e.*, the Punches, the Sorter and the Tabulator, are the basic machines in all punched card installations and comprise the essentials. The punches described, and to a lesser degree the sorters, are now largely supplemented by other ancillary machines which make the processing even more automatic.

The Reproducing Punch

This machine reproduces punched data from one set of cards into a new set. Thus unchanging data in, say, payroll cards, man's number, man's name, department, rate of pay, etc., can be reproduced from last week's cards into those of the current week without manual effort.

Electronic Calculator

This machine, which works at very high speed, replaces an earlier mechanical model and is used for extensions and cross-adding or deduction. It will, for example, sense from a punched card an employee's rate per hour and hours worked, multiply the two and punch the product into the same card. Simultaneously, bonus items could be added and tax deducted to arrive at the net wage.

Summary Card Punch

This is an entirely automatic slave machine which is coupled to a Tabulator. As the latter machine lists out and adds information from groups comprising maybe hundreds or thousands of detail cards, every time it strikes a total or balance, the Summary Card Punch punches a card to correspond. This greatly reduces the number of cards to be subsequently tabulated for further summaries or analyses.

The Interpreter

The Interpreter prints, on the face of a punched card, an interpretation, in ordinary characters, of the perforations in the card. Special models of the Interpreter provide

for 'posting' the interpretation of the punched card on to another card immediately following. It can thus be used, for example, for the posting of periodical payments to card records.

The Interpolator

This machine is designed to save sorting time and will accomplish in one passage of the cards what a Sorter may require several to do. It will, for example, in one passage interpolate opening balance cards into another pack comprising account movement cards, and should there be cards for unmoved balances they will be ejected. It is used for any work where matching (or marrying) is involved or for the segregation of unmatched cards.

Applications

The punched card machine installations differ from those with key operated machines in one important respect, namely, that it is unusual to find one installation devoted to one class of work. Except in very large organisations, therefore, one installation will be found to be doing quite a number of jobs such as invoicing, ledger posting, stores, payroll, and so on. The punched card lends itself to this way of working as once it has been punched it can be re-analysed for any number of tabulations and so it is quite usual to find invoicing and stores accounts, for example, produced from the same initial cards.

Invoicing

There are various methods of preparing invoices with punched card machines and naturally the procedure will vary according to the nature of the business but all, broadly, involve the use of:

(*a*) Name and Address cards, one card for each line and one set for each customer.

(*b*) Item cards, *i.e.*, one card which will print one line, for every item to be included on the invoice.

The Item cards can be prepared in a number of ways, the simplest being to use a pre-printed salesman's order for the original data and to punch the cards on an Automatic Key Punch.

If an electronic calculator is available it can be used to extend the price by quantity automatically. Similarly, discounts can be calculated and deducted from the gross value.

It may be possible to assemble the Name and Address and Item cards as the work proceeds or they may be sorted together mechanically. In any case, the grouped cards are then passed through the Tabulator to print out the invoice. The machine adds the values and prints out the totals automatically.

Simultaneously, a coupled Summary Card Punch will perforate a summary card which will contain all the identifying matter, Account No., etc., and the total amount to be debited to the customer's account. This summary card is filed until the appropriate time when it will be used for the preparation of the ledger account and statements.

The Item cards, after segregation from the Name and Address cards, are available for arriving at the credits to stock accounts, sales statistics and such allied work.

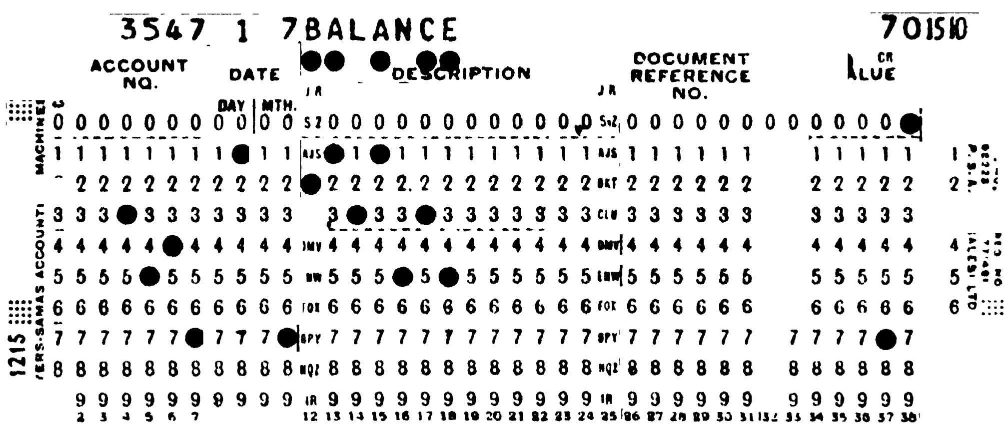
An alternative method of obtaining the Item cards is known as 'pre-punching' and this involves setting up files of pre-punched cards which physically represent the actual stock in hand. The cards are punched as the stock is received and a white card might represent a single item, a green card one dozen and a yellow card one gross.

If a sale of thirty-nine items is made, three green cards and three white cards would be extracted from the file to tabulate the invoice and the balance of cards left in the file represents the balance of goods left in stock. This method eliminates manual pricing and extending as well as punching at invoicing time and where it can be applied is very economical.

Ledger Posting and Statements

The following is a comparatively simple example of a card which records the balance brought forward on a ledger account on 1st July:

Illustration



The vertical lines divide the card into the appropriate 'fields'– in this case Account No., Date, Name or Description, Reference and Amount. The number of columns provided in each field is determined by the size of the organisation and the nature of the transactions that must be recorded. Thus, this card can record transactions concerning up to 999,999 different accounts in amounts not exceeding £99,999 19s. 11$\frac{3}{4}$d. for any one transaction. In addition to the field of alphabetical or numerical data, the two top horizontal rows can be used as controls in those columns in which they would otherwise be ignored. A good example of this is afforded by the DR. and CR. in columns 35 and 37 of the above card. The hole in the top row of column 35 not only records that the balance brought forward was a debit but in the subsequent operations of ledger posting for which this card will be used will activate the adding mechanism accordingly.

For ledger posting work a card similar to the above must be prepared for each entry to be made in the account. The principal debit cards, *i.e.*, those for goods

supplied, will be available as a by-product of the invoicing process, as mentioned above. Other cards for Cash, Discount Allowed, Journal, etc., are usually punched on the Automatic Key Punch. For the time being these cards, which are stored in convenient trays, constitute the current ledger. The actual work of reproducing the ledger in written form is normally a monthly routine which is made to coincide with the preparation of customers' statements in the case of the sales ledger or payment advice sheets in the case of the bought ledger. There are two procedures in common use the 'open item' method and the 'balance card' method.

Open Item Method

All the cards relating to each account are filed together in trays until a remittance is received (or, in the case of the bought ledger, a payment is made) which relates to specific items in the account. The cards for these specific items are then withdrawn or 'pulled' from the 'unpaid' tray and tabulated with the cash (and discount if applicable) card to prove by revealing 'nil' balances that the correct cards have been pulled and that the correct amount has been received or paid. The cards that have been pulled are then filed away in a 'paid' tray.

Where a payment 'on account' is received so that it does not clear specific items, the cash card itself is filed in customer and date order in the 'unpaid' tray.

At the end of the month, the cards in the 'unpaid' tray are merged with the name and address cards, this process being carried out most efficiently by the use of an 'interpolator' particularly where many of the accounts may not be 'active' each month. Name and address cards, arranged strictly in account number order, are inserted in the machine at one end while the pack of ledger cards, also in account number order, is inserted at the other end. The machine senses the account number holes in the first (*i.e.*, bottom) card of both packs. If they agree all the name and address cards followed by all the account cards relating to that one account are directed into one 'box' while if they do not agree (because the first name and address card is for an account for which there are no cards in the 'unpaid' ledger pack) the name and address cards only are discarded into a second box. The same machine is later used to separate the name and address cards from the account cards.

When all the 'unpaid' cards have been merged with name and address cards they are tabulated to produce a separate statement in duplicate for each customer. The tabulator automatically calculates and prints the balances and accumulates them to provide at the end of the run a grand total for agreement with the Ledger Control Accounts.

After the statements have been tabulated, and the name and address cards have been sorted out of the pack, the other cards are returned to the 'unpaid' tray and these constitute, in effect, the opening balances ready to recommence the cycle of operations next month. The carbon copies of the statements are filed in a sales ledger binder but these copies only show outstanding items on each customer's account and do not give any record of cash payments and completed transactions. To provide this information the cards from the 'paid' tray are posted by the tabulator on to individual customers' History Sheets, which are, in effect, the sales ledger record of all past and settled

transactions. After this posting has been completed all the 'paid' cards are filed away and are available for providing any statistics which may subsequently be required.

When the open item method is used 'balance' cards such as the one illustrated above will be prepared only in exceptional cases.

Balance Card Method

All the cards relating to each sales ledger account for the current month, including those recording cash settlements and a balance card recording the opening balance, are filed in the current ledger tray in account number order. At the end of the month they are merged with name and address cards and tabulated to produce a statement in duplicate, the total of the balances also being accumulated in the tabulator and agreed with the Control Account. The top copies of the statements are despatched to the customers while the carbon copies are filed to provide the permanent Sales ledger.

New balance cards having been prepared (if a Summary Card Punch is connected to the tabulator they will be prepared automatically; if not they must be punched by hand) and filed in the current trays as a starting point in the next month's routine, and the name and address cards having been withdrawn and returned to their file, the item cards for the past month are filed away.

Other applications

It would be quite beyond the scope of this work to attempt to describe in detail the large number of office routines that have been adapted to the punched card technique, many of them having only a remote connection with book-keeping in the ordinary sense. The following may, however, be noted:

The maintenance of stock methods.
The evaluation of stock in total by the method of 'digiting'.
Wages, including P.A.Y.E. routines.
Costing Systems.
Dividend and share transfer work.

§ 6. Electronic Computers

Computer techniques naturally follow on from punched cards and differ therefrom mainly in that more operations are carried on within one machine and consequently there is less physical handling of the media (punched cards or tapes) and corresponding savings in time. The electronic computer can also make certain decisions on its own and so needs less manual attention on the part of the operator.

There are now two main groups of machines. One group is designed to function in conjunction with orthodox punched card machines such as those already described. The data to be processed is punched into cards which are fed into the machine in the normal way and results are punched into cards which are later tabulated to obtain printed records.

The second group comprises larger machines which have the raw data fed in on perforated or magnetic tapes as well as punched cards. Such is their phenomenal speed (and some can accept up to 15,000 digits per second) that it is necessary to feed

in a number of tapes and batches of cards at the same time if full advantage is to be taken of potential calculating speeds. These large and very rapid machines are, however, unlikely to be justifiable, on the grounds of cost, except in the largest organisations.

Punched card computers, however, are coming into quite wide use and the main advantage of such machines is their speed which enables them to take into account many more factors than can be economically handled by other methods.

In the case of a wages application, for example, the storage (memory) accommodation in the machine can be used to hold the rates of income tax and the stages of taxable income at which they should be applied. Thus when a card is fed into the machine and the taxable income is compared with the taxable stages, it can decide if tax is chargeable and, if so, calculate how much the charge should be. This is done in single stages as the machine can only choose between two alternatives and if there are many it must make many attempts.

If, for example, tax is chargeable on the following simple imaginary scale:

First £200 income at 1s. in £1,

£201 – £400 income at 2s. in £1,

£401 – £600 income at 3s. in £1,

then if an individual's earnings are, say, £550, the computer will compare this with £400 (in the memory) and finding it greater will deduct and find £150 is to be taxed at 3s. in the £1.

Then the next stage will compare the balance with £200 and finding a difference of £200 calculate tax at 2s. in £1. After all such comparisons and calculations are made the items of tax are added together and deducted from the gross pay.

As an example of the speed of these medium sized computers the Power-Samas P.C.C. (Program Controlled Computer) can effect all the calculations in connection with an individual's pay in one-half-second. Such a machine does not print but records its results on punched cards which in turn are printed out on a tabulator.

CHAPTER XII

THE DOUBLE ACCOUNT SYSTEM

§ 1. Definition

The Double Account system is not a system of book-keeping but a method of presenting final accounts, the object of which is to show clearly the total amount of capital that has been raised for the purpose of the undertaking and the manner in which that capital has been applied in the acquisition of fixed assets and other forms of capital expenditure. In order to do this, the Balance Sheet is divided into two parts. The first part is called the Capital Account and shows on the credit side all capital receipts (including receipts from debentures and loans), and on the debit side all capital expenditure to date. The balance of the Capital Account is carried to the Balance Sheet proper, which contains, in addition to such balance, particulars of the current assets and liabilities, revenue balances, reserves, etc.

Until a few years ago, the double account system was used compulsorily by such public utility concerns as railways, gas, electricity and water companies, which, in consideration of the monopolies given by the special Acts of Parliament under which they were constituted, were required to present their accounts in the form laid down by those Acts.

Most of these undertakings have now been brought under state ownership, and the statutes by which they were nationalised do not prescribe the use of the double account system, but merely require that the accounts shall be prepared in a form which conforms with the best commercial standards.

The expression 'double account' must not be confused with 'double entry'. Double entry is applied to the double account system in the same way as to the single account system, and ledger accounts are kept of each class of capital expenditure and capital receipt. The Capital Account itself is not a ledger account, but is prepared from balances standing in the books. For this purpose it is convenient to utilise a separate capital ledger containing only those items which go to make up the Capital Account. Thus it will be seen that the outstanding features in the double account system only become apparent in the preparation of the final accounts, and do not affect the actual book-keeping.

Illustration

THE OLD LAKE WATER COMPANY
CAPITAL ACCOUNT FOR THE YEAR ENDED 30TH JUNE, 1959

	£		£
To Expenditure brought forward ..	2,309,607	By 7% Ordinary Stock ..	1,000,000
„ Expenditure during year ended 30th June	65,206	„ 5% Ordinary Stock ..	200,000
„ Balance (carried to Balance Sheet)	25,187	„ 4½% Preference Stock ..	500,000
		„ 3% Redeemable Debenture Stock	500,000
			2,200,000
		Premiums *less* Discounts	200,000
	£2,400,000		£2,400,000

REVENUE ACCOUNT FOR THE YEAR ENDED 30TH JUNE, 1959

	£		£
To Pumping and Engine Charges	141,214	By Water Rates and Charges	521,385
„ Softening of Water	42,180	„ Registration Fees	52
„ Maintenance and Repairs of Works	26,510	„ Rents	4,273
„ Maintenance and Repairs of Mains	55,789		
„ Salaries	35,200		
„ Rates	69,172		
„ Insurance	2,930		
„ Directors' Fees	5,000		
„ Auditors' Fees	750		
„ Superannuation Fund	1,800		
„ Contributory Pension Fund	12,850		
„ General Establishment Charges	11,524		
„ Legal and Parliamentary Charges	2,500		
	407,419		
„ Balance (carried to Net Revenue Account)	118,291		
	£525,710		£525,710

NET REVENUE ACCOUNT

	£		£
To Interest on Debenture Stock (Net)	8,625	By Balance brought forwaid	59,280
„ Dividend on Preference Stocks (Net)	12,938	*Less* Final Dividend on Orc previous year	23,000
„ Interim Dividend on Ordinary Stocks (Net)	23,000		36,280
„ Income Tax	51,982	„ Profit for year ended 30th Jun	118,291
„ Provision for Discounts and Expenses of Issue	250	„ Profit on Sale of Investments	1,250
„ Balance (carried to Balance Sheet)	63,526	„ Interest on Investments	4,500
	£160,321		£160,321

BALANCE SHEET AS AT 30TH JUNE, 1959

	£		£
Capital Account	25,187	Stores on hand	43,444
Net Revenue Account	63,526	Debtors	45,276
Contingency Fund Account	65,820	Investments, at cost	112,618
Reserve Fund Account	101,000	Contingency Fund Investments, at cost	52,500
Creditors	135,275	Reserve Fund Investments, at cost	102,760
		Cash and Bank Balances	34,210
	£390,808		£390,808

§ 2. Treatment of Capital Losses

Under the strict theory of the double account system all capital expenditure is shown in the Capital Account, whether or not it continues to be represented by assets. Losses on Capital Account, therefore, occasioned by the abandonment of assets which can be no longer profitably utilised, or by depreciation of assets which are not required to be renewed, need not, in strict theory, be provided for. Since this would usually be unsound from a financial point of view, although no provision is made for writing off such losses in the statutory forms of account, it is desirable that they should be ultimately provided for out of revenue, and in most cases, in practice, it is found that capital losses are actually written off, either by being deducted in the Capital Account, or by the creation of a reserve of equal amount, the former method being the more common. The loss is debited either to a Reserve Account previously created, or direct to the Revenue Account. If too large to be written off in any one year it may be written off over a period.

§ 3. Renewal and Depreciation Funds

It has already been said that depreciation of assets requiring renewal is not provided for in the usual manner by debiting revenue and crediting the asset account, but that all repairs, renewals and replacements are charged to revenue as and when they arise, and that this rule is subject to variation in practice.

It will be apparent that if no provision were made for large renewals and replacements until they actually occurred, the revenue of that period would be burdened with a charge out of all proportion thereto, which in many cases might have the effect of preventing the payment of a dividend in respect of that period, although in fact a profit had been earned.

During the early years of an undertaking working under this system, the renewals and replacements in respect of the principal assets, such as plant, etc., will be comcomparatively light, and unless provision is made for the future renewals, the profit will appear to be considerably greater than if provision for depreciation were taken into consideration, and will admit of dividends being paid which would not be possible if proper provision for renewals had been made. In actual cases where this policy has been pursued, dividends on the ordinary stocks have had to be greatly reduced, and in some cases suspended altogether, as soon as heavy replacements became necessary.

Although there is no statutory compulsion to provide for future renewals, there is nothing to prevent companies working under the double account system from forming proper renewal funds during the early years of the undertaking for the future replacement of their assets, and this should certainly be done, and is in fact done by all companies which are managed on the most prudent lines.

After a certain period, if the undertaking is sufficiently large, the renewals will reach a steady average from year to year, and further additions to the renewal fund may cease to be necessary.

In many instances replacements take place which involve an extension of the original asset, and the question then arises as to what proportion of the replacement can be charged to capital as representing the value of the extension, and what proportion should be charged to revenue as representing a replacement of the original asset. In such cases, many concerns adopt the usual principle of capitalising the whole of the excess of the cost over that of the original asset. Under the strict double account system, however, the method described and illustrated below is adopted.

The present cost of replacing the asset as it stands is estimated, and this amount is charged to revenue, whether or not it is more than the original cost of the asset. The balance of the expenditure is then charged to capital as representing the cost of the extension. Under either method, the amount received in respect of the break-up value of the asset replaced should be credited to revenue against the cost of replacement. Any of the old materials used in the new structure should be valued, and charged to the cost, being credited to revenue.

Illustration

A building originally costing £60,000 is replaced by a new and enlarged building costing £140,000, £6,000 being realised from the sale of old materials. The estimated cost of replacing

the old building as it stood was £75,000. How should the £140,000 be apportioned as between capital and revenue?

Under the strict double account system, £75,000, the estimated cost of replacement of the building as it stands, should be charged to revenue, as against which can be set the £6,000 realised from the sale of old materials, leaving a net charge of £69,000. £65,000 will be debited to capital as representing the cost of extension, making the total debit to capital in respect of the building £125,000.

In practice, however, it will often be found that the book value of the old asset is written off to revenue, and the whole cost of the new asset capitalised in the same way as under the single account system.

CHAPTER XIII

BANKRUPTCY, LIQUIDATION AND RECEIVERSHIP ACCOUNTS

§ 1. The Preparation of a Statement of Affairs in Bankruptcy

Within three days of the making of the receiving order, if made on the debtor's own petition, or within seven days if made on a creditor's petition, the debtor must lodge with the Official Receiver his Statement of Affairs. This must be compiled in the official form, and be accompanied by the following schedules of particulars:

A. Unsecured creditors.

B. Creditors fully secured.

C. Creditors partly secured.

D. Liabilities of debtor on bills discounted other than his own acceptances for value.

E. Contingent or other liabilities.

F. Creditors for rent, etc., recoverable by distress.

G. Preferential creditors for rates, taxes and wages.

H. Property.

I. Debts due to the Estate.

J. Bills of Exchange, Promissory Notes, etc., available as assets.

K. Deficiency Account.

In the illustration that follows, a *pro forma* example of the front sheet of a Statement of Affairs and the Deficiency Account is given.

The method of preparing this Statement of Affairs follows very much the lines of the preparation of a Statement of Affairs for the purpose of placing a system of books on a double entry basis. Where, however, the books have been kept on a double entry system, although the preparation of the statement will be greatly facilitated thereby, at the same time many points will require to be dealt with which would not arise in the preparation of a Balance Sheet in the ordinary manner. The principal of these are as follows:

(a) Unsecured Creditors

A schedule of these creditors must be prepared in the prescribed form, containing particulars of name, address and occupation, the amount of the debt, the date when contracted, and the consideration given. All liabilities, whether in respect of trading operations or otherwise, which cannot be listed in any of the other schedules, must be included here, particularly bills payable on which the debtor is liable as acceptor for value, the necessary particulars of each bill being inserted; bank overdraft if unsecured; balance of rent, etc., not recoverable by distress; and of creditors for wages,

etc., in excess of the limit allowed as a preferential payment. Where there is a contra account against a creditor, only the net balance must be included, the debt being reduced to the extent of the contra.

(b) Creditors fully secured

The schedule of these creditors, in addition to containing the same information as is necessary in respect of unsecured creditors, must also contain particulars of the security held, the date when the security was given, the estimated value of the security, and the estimated surplus. On the liabilities side of the statement of affairs these creditors will be entered in short, the security being shown as a deduction, and the surplus carried to the assets side. If, however, partly secured creditors have a second charge on any or all of such surplus, the amount so charged is deducted from the surplus (only the balance of which (if any) is carried to the assets side), and added to the securities of the partly secured creditors (*see* (*c*) below).

Where the creditor holds security of a third party for the liability of the debtor, such security must be ignored; the asset forming the security does not belong to the debtor, and the creditor, so far as the bankrupt's estate is concerned, is unsecured.

If the debtor has given security for the debt of a third party, the creditor of that third party is a fully secured creditor of the debtor giving the security. In such a case, the creditor should be included here, but his claim must be reduced by the amount expected to be paid by such third party, *i.e.*, if the third party is solvent, there will be no debt to rank here, and the securities will appear among the assets in the statement of affairs. Full details will, of course, appear in the schedule of liabilities.

(c) Creditors partly secured

Similar particulars must be afforded in this schedule, and the unsecured balance shown. In the Statement of Affairs these creditors are shown in short on the liabilities side, the security being deducted, together with any surplus from fully secured creditors over which the partly secured creditors have a second charge, and the balance unsecured, which ranks against the estate, extended.

(d) Liabilities on Bills Discounted other than Debtor's own Acceptances for value

The schedule of these bills must contain in respect of each bill particulars of the acceptor's name, address and occupation, whether the debtor is liable as drawer or indorser, the date when the bill falls due, the amount of the bill (accommodation bills being separated from other bills), the name, address and occupation of the holder (if known), and the amount expected to rank against the estate for dividend.

Bills receivable discounted by the debtor with his bank or other parties will be included here, since the debtor will be liable on the bills as drawer or indorser. If, however, it is expected that the acceptor will meet these bills in due course, nothing will be extended to rank against the estate for dividend.

The case of accommodation bills is more complicated, especially where there have been cross-transactions between the debtor and another party. Briefly, the whole of the accommodation bills must be inserted, whether the debtor is liable as drawer,

acceptor, or indorser. Each accommodation bill must be examined, to ascertain the precise nature of the liability attaching to it as regards the estate. Where the accommodation bill was accepted by the debtor, the amount ranking for dividend will be the face value less the amount expected to be recovered from any person who shared in the proceeds of discounting it. If there is no such estimated recovery, the full face value will rank for dividend, unless the bill has not been negotiated. If the debtor is only liable as drawer or indorser, it will depend on the financial position of those primarily liable on the bill how much (if any) of the amount should be extended as ranking for dividend. If the party primarily liable dishonours the bill and becomes bankrupt, the holder will have a right of proof to the full extent of the bill against the estates of both parties, though he will not be entitled to receive dividends exceeding the total face value of the bill, together with interest and expenses.

As previously stated, liabilities on bills payable accepted by the debtor for value will be included in the list of unsecured creditors, and not in this schedule. In the Statement of Affairs the gross amount of liabilities on bills discounted other than the debtor's own acceptances for value is shown in short, and only the amount expected to rank for dividend extended.

(e) Contingent or other liabilities

The chief claims under this heading will be under contracts of guarantee or suretyship, claims for dilapidations under leases, uncalled capital on partly-paid shares, etc. In these cases the gross amount is inset and only the amount expected to rank for dividend extended. Any amount recoverable from other persons will be considered when arriving at the amount expected to rank.

(f) Creditors for Rent, etc., recoverable by distress, and Preferential Creditors

The schedules of these items must contain full particulars, and disclose the difference between the gross amounts of the claims and the amounts recoverable by distress, or payable in full under the Bankruptcy Act. The amounts not so recoverable or payable in full will be included in the list of unsecured creditors. In the Statement of Affairs the amount recoverable or payable in full will be shown in short on the liabilities side, and deducted from the gross assets on the assets side.

The landlord is entitled to recover by distress any rent in arrear, up to a maximum of six months' rent, accrued due up to the date of the adjudication order, and since the statement of affairs is usually prepared prior to this date, if any rent is accrued due, such amount, but not exceeding six months' rent, should be included. Any balance should be included with the amounts due to unsecured creditors.

If the landlord distrains within three months of the receiving order, preferential debts are a first charge upon the goods or proceeds of sale, the landlord having the same rights of priority in place of the persons preferred. If, therefore, there are insufficient assets to cover the preferential debts and the rent accrued within the six months, the landlord's claim will be restricted to the excess of the available assets over the preferential debts.

The Bankruptcy Act, 1914, as amended by Sec. 115, Companies Act, 1947, provides

for certain classes of liabilities to be paid in priority to others, and these should be treated as indicated above. The following is a list of such preferential debts:

(1) Parochial and local rates due at the date of the receiving order and having become due and payable within the twelve months next before the receiving order. If the rates are payable by instalments, only the instalments *due* should be entered. If the premises have been vacated prior to the receiving order, only the apportioned rates to the date of vacating the premises should be included, since no rates are payable when the premises are not occupied.

(2) All land tax, income tax, surtax, or other assessed taxes assessed on the debtor up to the 5th April next before the receiving order, not exceeding one year's assessment. Where more than one year's assessment is in arrear, the highest amount will be treated as preferential, the balance being unsecured.

The expression 'assessed up to 5th April next before the receiving order' includes tax due for the period up to the previous 5th April, even though not actually assessed before that date (*Gowers* v. *Walker* (1930), 1 Ch. 262).

(3) Any tax deducted from emoluments under P.A.Y.E. for the twelve months next before the receiving order (*Finance Act*, 1952, § 30).

(4) Any unpaid purchase tax which became due to the Crown in the twelve months preceding the date of the receiving order.

(5) Wages or salary of any clerk, servant, labourer or workman in respect of services rendered during the four months before the receiving order, with a maximum of £200 for each individual. Holiday or sick pay ranks as payment in respect of services.

(6) Any sum ordered to be paid under the Reinstatement in Civil Employment Act, 1944, by way of compensation, not exceeding £200 for any individual. Similar compensation ordered under the National Service Act, 1948 or the Reinstatement in Civil Employment Act, 1950, not exceeding £50.

(7) All accrued holiday remuneration becoming payable to any clerk, servant, workman or labourer (or in case of his death to any other person in his right) on the termination of his employment before or by reason of the receiving order.

(8) Under the Workmen's Compensation Act, 1925, any sum due in respect of compensation, the liability wherefor accrued before the date of the receiving order in satisfaction of a right which arose in respect of employment before 5th July, 1948 (unless the debtor was insured, in which case his rights under the policy are transferred to the workman, who is then an ordinary creditor to the extent that the insurance is insufficient).

(9) Under the National Insurance Act, 1946 and the National Insurance (Industrial Injuries) Act, 1946, all contributions payable during the twelve months prior to the

receiving order by the debtor as an employer of any person.

The following claims rank even before the above:

(1) Funds belonging to a friendly society or trustee savings bank, which are in the hands of the debtor as an officer of the society.

(2) The proportion of an articled clerk's premium, as the trustee shall decide, where the employer becomes bankrupt, and the trustee does not transfer the Articles to some other person.

(3) Reasonable funeral and testamentary expenses in the case of a deceased insolvent debtor.

(4) The expenses properly incurred by the trustee under a deed of arrangement which was avoided by the bankruptcy of the debtor.

(g) Deferred Debts

The following classes of debts do not rank for dividend until all other unsecured creditors have been paid in full:

(1) Money lent by a married woman to her husband for the purpose of his trade or business, or by a husband to his wife in similar circumstances.

(2) Money lent to a firm, the lender to receive a share in the profits instead of interest, or a rate of interest varying with the profits; or money due to the vendor of goodwill (where he is being paid by way of an annuity or share of profits).

(3) Beneficiaries under an ante-nuptial agreement to settle after-acquired property, if the agreement becomes void against the trustee should the settlor become bankrupt.

(4) Interest on debts in excess of 5 per cent. In bankruptcy (but not in liquidation), this is not payable until all creditors have been paid in full. 4 per cent interest is also payable on all debts from the date of the receiving order to the final payment when all the debts are paid in full and all other claims for interest have been met.

Deferred debts must, nevertheless, be included in the list of unsecured creditors, since the question of postponement is dealt with when proofs of debts are scrutinised for voting and dividend purposes, and not at this early stage. The deferred debts are therefore not distinguished in the Statement of Affairs.

In all cases, the gross liabilities must be entered in the 'gross liabilities' column, whether secured or not, and even though part may be met by third parties.

(h) Valuation of Assets

All assets should be brought into the Statement of Affairs at a fair estimate of their realisable value. Care must be taken to see that the debtor does not over-estimate the break-up value. Stock must be valued with particular reference to the conditions under which a forced realisation might have to be made. Similar considerations apply to the valuation of other assets, such as freehold and leasehold properties, machinery and plant, fixtures, furniture, etc. Private assets, such as furniture and investments, must be included, as these are available to satisfy *any* liability of the debtor.

Property held in trust for others must be excluded, also the tools and necessary wearing apparel and bedding of the debtor, his wife and children, to an inclusive value of £20.

No account can be taken of any property which the trustee may be expected to recover under the 'doctrine of relation back' or the 'reputed ownership' clause.

A full description of every kind of property must be made in the specified form, together with the statement of the amount it is expected to produce.

(i) Book Debts

A schedule of debts due to the estate must be prepared, showing the name, address and occupation of the debtor, the amount of the debt, distinguishing between good, doubtful and bad; the date of contraction, the amount each debt is estimated to produce, and particulars of any securities given for debts. In the Statement of Affairs the amount of the good debts is extended into the outer column; the doubtful and bad debts are shown in short at their gross figure, and the amount they are estimated to produce extended.

(j) Bills of Exchange, etc., on hand

Bills deposited with bankers for collection (not discounted) must be included.

(k) The Deficiency Account

The excess of liabilities expected to rank against the estate over the net assets available to meet those liabilities is termed the 'deficiency', or in the event of the assets exceeding the liabilities, the 'surplus'. A Deficiency Account is prepared in order to disclose how the deficiency or surplus has arisen.

On reference to the form of this account shown in the subsequent example, it will be seen that the account starts with what is in effect either the capital of the debtor at a given date, or the deficiency at that date; the date in question being either one year prior to the date of the receiving order, or such other date as the official receiver may fix.

On the debit side of the Deficiency Account will be found the various items which go to make up the total amount to be accounted for. These are as follows:

(1) Excess of assets over liabilities at commencement of period under review (if any). Care must be taken to bring in private as well as business capital.
(2) Net profits (if any) from the business during the period under review, before charging interest on capital or proprietor's salary.
(3) Any other receipts. There must also be included any gifts, *e.g.*, legacies received during the period.
(4) Deficiency (if any), as per Statement of Affairs.

The total of these will be accounted for on the credit side of the Deficiency Account as follows:

(1) Excess of liabilities over assets (if any) at the commencement of the period under review.
(2) Net loss (if any) from carrying on business during the period.

(3) Bad debts. Care must be taken to include those written off in arriving at the amount estimated to be produced from debtors in the Statement of Affairs.

(4) Expenses incurred during the period, other than usual trade expenses, viz., household expenses and personal expenses of self, wife and children.

(5) Other losses and expenses.

(6) Surplus (if any).

The item 'Other Losses and Expenses' will include the difference between the book value of the assets appearing in the Statement of Affairs and the amount they are estimated to produce, or, in the case of private assets, the difference between the value taken in arriving at the opening capital and the amount they are estimated to produce; also the loss incurred in respect of all liabilities ranking against the estate for dividend for which no consideration has been received, such as estimated loss on bills discounted or accommodation bills, and contingent liabilities expected to rank. These various losses should be shown in detail.

It should be observed that the entries made in the Deficiency Account have the effect of completing double entry with those in the Statement of Affairs and that a 'debit balance' in the one corresponds with a 'credit balance' in the other. If, for example, a year ago a debtor had assets of a book value of £5,000 and liabilities of £3,000, and since that date he had increased his assets by a profit of £500 and reduced them by drawings of £1,000, the Statement of Affairs would reveal a surplus, on the basis of book values, of £1,000, which would correspond with the surplus disclosed by the Deficiency Account.

STATEMENT OF AFFAIRS

	£		£
Liabilities	3,000	Assets	4,500
Surplus	1,500		
	£4,500		£4,500

DEFICIENCY ACCOUNT

	£		£
Excess of Assets over Liabilities one year previously	2,000	Drawings	1,000
Profits	500	Balance, being surplus as per Statement of Affairs.	1,500
	£2,500		£2,500

If, however, it is now found that the realisable value of the assets is only £2,500, the Statement of Affairs will, in effect, be debited with the loss of £2,000 and the Deficiency Account must be credited with the same amount. Again, if additional liabilities of £200 come to light, the Statement of Affairs must be debited and the Deficiency Account credited with that amount. The effect of these entries would be to convert the surplus of £1,500 into a deficiency of £700, thus:

STATEMENT OF AFFAIRS

	£		£
Liabilities	3,000	Assets	2,500
Additional Liabilities ..	200	Deficiency	700
	£3,200		£3,200

DEFICIENCY ACCOUNT

	£		£
Excess of Assets over liabilities one year previously ..	2,000	Drawings ..	1,000
Net Profit	500	Loss on realization of assets	2,000
Balance, being Deficiency as per Statement of Affairs	700	Additional liabilities	200
	£3,200		£3,200

It will thus be seen that the Deficiency Account must be credited with the amounts by which the estimated realizable value of assets as shown by the Statement of Affairs fall short of their book values, and with any amounts by which the liabilities estimated to rank against the estate, as shown by the Statement of Affairs, exceed book values. Similarly, if the estimated realizable value of an asset is greater, or the amount of a liability proves to be less, than its book value, the Deficiency Account must be debited with the amount of the difference, the credit for which has, in effect, been made in the Statement of Affairs.

Illustration

A filed his petition on 31st December, 19 , and his Statement of Affairs was composed of the following figures:

	£
Creditors unsecured	75,000
Creditors partly secured by lien on Shares ..	40,000
Creditors fully secured by lien on Stock .. .	100
Liability on Bills Receivable (estimated to rank £3,500)	7,000
Mortgage on Mill	10,000
Creditors payable in full	3,000
Book Debts, good	20,000
Book Debts, doubtful (estimated to produce £2,000)	4,000
Book Debts, bad	6,000
Consignments, good	5,000
Stock (estimated to realise £40,000) . ..	60,000
Shares (cost and estimated to realise) . .	16,000
Cash at Bankers	200
Bills of Exchange	1,300
Mill of the value of	11,000
Machinery (estimated to realise £12,000)	15,000
Fixtures (estimated to realise £1,500)	3,000
Cottages (estimated to realise £3,000)	3,500

One year previously he had a capital of £20,000. A loss of £700 was made in the year, after allowing interest on capital £1,200, and withdrawals amounted to £3,600.

Prepare the Statement of Affairs and Deficiency Account.

No. 46 **In the** **Court of**

IN BANKRUPTCY No 19

Statement of Affairs RE A

STATEMENT OF AFFAIRS

At 31st December 19.., date of Receiving Order

Gross Liabilities	Liabilities (as stated and estimated by Debtor)		Expected to Rank	Assets (as stated and estimated by Debtor)		Estimated to produce
			£			£
75,000	Unsecured Creditors as per List (A)		75,000	Property as per List (H), *viz.*:		
				(*a*) Cash at Bankers		200
		£		(*b*) Cash in hand		
10,100	Creditors fully secured, as per List (B)	10,100		(*c*) Cash deposited with Solicitor for Costs of Petition		
	Estimated value of securities	11,100		(*d*) Stock-in-Trade (cost £60,000)		39,900
				(*e*) Machinery		12,000
	Surplus	1,000		(*f*) Trade fixtures, fittings, utensils, etc.		1,500
	Less amount thereof carried to Sheet (C)			(*g*) Farming stock		
				(*h*) Growing crops and tenant rights		
				(*i*) Furniture		
	Balance thereof to contra	£1,000		(*j*) Life Policies		
				(*k*) Other property, *viz*:		
				Cottages		3,000
40,000	Creditors partly secured, as per List (C)	40,000		Consignments		5,000
	Less estimated value of securities	16,000				
			24,000			
	Liabilities on Bills discounted other than Debtor's own acceptances for value, as per List (D), viz:					
	On Accommodation Bills as Drawer, Acceptor, or Indorser			Total as per List (H)		61,600
	On other Bills as Drawer or Indorser	7,000		Book Debts as per List I), *viz*:		
				Good		20,000
		£7,000		Doubtful	£4,000	
				Bad	6,000	
					£10,000	
3,500	Of which it is expected will rank against the estate for dividend		3,500			
	Contingent or other Liabilities as per List (E)			Estimated to produce		2,000
	Of which it is expected will rank against the estate for dividend			Bills of Exchange or other similar securities on hand, as per List (J)	£1,300	
				Estimated to produce		1,300
	Creditors for rent, etc., recoverable by distress, as per List (F)			Surplus from securities in the hands of Creditors fully secured (per contra)		1,000
3,000	Creditors for rates, taxes, wages, etc., payable in full, as per List (G)	3,000				85,900
	Sheriff's charges payable under § 41 of the Bankruptcy Act, 1914, estimated at			Deduct Creditors for distrainable rent, and preferential rates, taxes, wages, sheriff's charges, etc. (per contra)		3,000
						82,900
	Deducted contra	£3,000		Deficiency explained in Statement (K)		19,600
£131,600			£102,500			£102,500

No. 46

Statement of Affairs

K

List K

DEFICIENCY ACCOUNT

		£
Excess of assets over liabilities on the (1) 1st day of January, 19.. (if any)		20,000
Net Profit (if any) arising from carrying on business from the (1) 1st day of January, 19.., to date of Receiving Order, after deducting usual trade expenses .		500*
Income or profit from other sources (if any) since the (1) day of 19..		
Deficiency as per Statement of Affairs .		19,600
Total amount to be accounted for	(5)	£40,100

Excess of liabilities over assets on the (1) day of 19 (if any)		
Net loss (if any) arising from carrying on business from the (1) day of 19 ., to date of Receiving Order, after deducting from Profits the usual trade expenses		
Bad debts (if any) as per Schedule 'I' (2)		8,000
Expenses incurred since the (1) 1st day of January, 19 , other than usual trade expenses, *viz.*, household expenses of self and (3)		3,600
(4) Other losses and expenses (if any)		
On Stock-in-Trade	20,000	
Machinery .	3,000	
Fixtures . . .	1,500	
Cottages . ..	500	
Bills Receivable Discounted	3,500	
		28,500
Surplus as per Statement of Affairs (if any)		
Total amount accounted for . .. (5)		£40,100

Signature

Dated *19*

Notes

(1) This date should be 12 months before date of Receiving Order, or such other time as Official Receiver may have fixed.

(2) This Schedule must show when debts were contracted.

(3) Add 'wife and children' (if any), stating number of latter.

(4) Here add particulars of other losses or expenses (if any), including depreciation in the value of stock and effects or other property as estimated for realisation, and liabilities (if any) for which no consideration received.

(5) These figures should agree.

* The profit before charging Interest on Capital was £1200—£700=£500.

(l) Bankruptcy of Partnerships

When a partnership is made bankrupt, the trustee of the joint estate becomes also the trustee of the separate estate of each partner. A Statement of Affairs, with Deficiency Account, must be prepared for the firm, and separate Statements of Affairs and Deficiency Accounts for each partner. Distinct accounts must be kept of the joint and separate estates, the separate creditors of each estate being first paid out of the assets of that estate. In the event of there being a surplus on any of the separate estates, this will form an asset of the joint estate, but the joint creditors cannot receive more than the full amount of their debts, together with 4 per cent. per annum interest from the date of the order. Any surplus on the joint estate will be divided between the partners, according to their rights under the partnership agreement and each partner's share will be included as an asset of his separate estate.

Where a partner has given personal security as collateral to his guarantee of a debt due from the firm, the creditor can prove against the firm as an unsecured creditor for the whole debt, and against the partner as a creditor for the excess of his debt over the value of the security, the difference representing the liability of the separate estate in respect of the guarantee (*Re Turner, ex parte West Riding Bank* (1881) 19 Ch. D. 105.) Dividends declared in respect of the separate estate will be withheld until it is ascertained what amount the creditor will receive from the joint estate, as he cannot receive, in the aggregate, more than 20s. in the £.

Illustration

X and Y are in partnership and file their petition in bankruptcy. From the following particulars, prepare the Statements of Affairs and Deficiency Accounts of the joint estate and the separate estates of the partners.

BALANCE SHEETS

	X & Y	X	Y		X & Y	X	Y
	£	£	£		£	£	£
Mortgage of Freehold	3,000			Freeholds	6,000		
Bank Overdraft	3,000			Plant	6,500		
Sundry Creditors	12,400	1,500	2,900	Furniture	400	1,000	1,200
Preferential Creditors	100			Stock	5,500		
Capital X	3,000			Debtors	5,000		
,, Y	2,000			Investments		2,500	800
Surplus		5,000	1,100	Cash	100		
				Capital in X and Y		3,000	2,000
	£23,500	£6,500	£4,000		£23,500	£6,500	£4,000

The bank overdraft was secured by a second mortgage on freeholds, and by Y's personal guarantee, supported by the deposit of Y's investments as collateral security.

The firm's assets are estimated to realise the following: Freeholds, £4,500; Plant, £3,000; Furniture, £150; Stock, £3,100; Debtors, good, £2,575; doubtful (£1,000) 10s. in £; bad (£1,425) nil. X's assets: Furniture, £600; Investments, £2,000. Y's assets: Furniture, £800; Investments, £300.

STATEMENTS OF AFFAIRS

(*Note.* In practice each would be on a separate form)

	£	X & Y £	X £		Y £
Unsecured Creditors ..		12,400	1,500		2 900
Fully Secured Creditor ..	3,000				
Estimated value of security	4,500				
Surplus to partly secured Creditor	1,500				
Partly Secured Creditor	3,000				1,500
Estimated value of security .. .	1,500			300	
		1,500			1,200
Preferential Creditors deducted contra	100				
Surplus carried to Joint Estate ..			1,100		
		£13,900	£2,600		£4,100

		X & Y £	X	Y
Cash		100		
Stock .		3,100		
Plant .		3,000		
Furniture		150	600	800
Investments . .			2,000	
Surplus from X's Estate		1,100		
		7,450	2,600	800
Debtors Good		2,575		
,, Doubtful	£1,000			
,, Bad	1,425			
	£2,425			
Estimated to produce		500		
		10,525	2,600	800
Less Preferential debts		100		
		10,425	2,600	800
Deficiency		3,475		3,300
		£13,900	£2,600	£4,100

Note.

As the joint estate will be able to pay the creditors only 15s. in the £, the bank will take over the whole of Y's investments towards the balance remaining (£375). The bank will, however, be entitled to prove in Y's estate for the full amount of £1,500, *less* £300, the value of the investments. It cannot, however, receive, in the aggregate, more than 20s. in the £. The proof would be made in the firm's estate for £1,500, the value of the investments not being deducted, as they were lodged by and belonged to Y, and did not form part of the estate of the firm.

DEFICIENCY ACCOUNTS

	X & Y £	X £	Y £
Capital .. .	5,000	5,000	1,100
Surplus from X's Estate .	1,100		
Deficiency as per Statement of Affairs .	3,475		3 300
	£9,575	£5,000	£4,400

	X & Y £	X £	Y £
Losses: Stock ..	2,400		
Plant	3,500		
Furniture	250	400	400
Debtors	1,925		
Freeholds .	1,500		
Investments .		500	500
Guarantee .			1,500
Capital in X and Y .		3,000	2,000
Surplus as Statement of Affairs		1,100	
	£9,575	£5,000	£4,400

§ 2. The Accounts of a Trustee in Bankruptcy

Detailed accounts must be kept by the trustee in a cash book of all his receipts and payments. This book must be in the prescribed form, and contain columns for every class of receipt and payment. The following is the form provided:

:tration

TRUSTEE CASH BOOI

RECI							
Part	Tota	Drawr from Bank	Debts ollecte	Property Realised	Receipts from Securities held by Customers	Other Receipts	

PAY															
aid in Bank	Board of Trade and Court Fees	Law Costs of petition (including stamp)	Law Costs after Receiving Order	Costs of Commission on Realisation and Distribution	PA Charges of Auctioneer, Accountant, Shorthand Writer, etc., as taxed	Notices in *Gazette* and Local Paper	Incidental Expenses, including Possession	Allowance to Debtor	Preferential Creditors and Rent	Payments to Redeem Securities	Dividends Paid	Other Payments	Voucher Nos. (in red)	Total	C

At the expiration of six months from the date of the receiving order, and every succeeding six months until his release, the trustee must send to the Board of Trade a duplicate copy of the cash book for such period, together with the necessary vouchers and copies of the certificate of audit by the committee of inspection. One copy of the cash book so required will be in the form shown above; the other copy is simply a summarised form without the detail columns.

If the trustee carries on the business of the debtor, he must keep a Trading Account recording simply the cash receipts and payments. This account must be kept in the prescribed form, and only the weekly total of the receipts and payments need be inserted in the general cash book.

At the date of declaring the first and each subsequent dividend, and at the date of application by the trustee for release, he must prepare a summarised statement of receipts and payments in the prescribed form, showing the position of the estate at the date in question. A copy of this statement must be sent to each creditor who has proved, and to the debtor.

§ 3. Deeds of Arrangement

Where a trustee is appointed under a private deed of arrangement, it is usual for a Statement of Affairs to be presented to the creditors, drawn up more or less on the lines of a Statement of Affairs in bankruptcy, but disclosing considerably less detail. A list of creditors is also usually furnished.

The trustee under a deed of arrangement is not compelled to keep a columnar cash book similar to that required to be kept by a trustee in bankruptcy; but he must, within 30 days after the expiration of 12 months from the date of the registration of the deed, and again on finally ceasing to act, transmit to the Board of Trade an account of his receipts and payments as trustee, sufficient indication being given of each receipt and payment to explain its nature.

Where trading is carried on, a separate Trading Account must be kept, and the totals entered in the cash account.

By Section 14 of the Deeds of Arrangement Act, 1914, it is provided that every trustee under a deed of arrangement must send, every six months from the registration of the deed, to each creditor who has assented to the deed, a statement in the prescribed form, of the trustee's accounts and of the proceedings under the deed to the date of the statement. This is in addition to the Statement of Accounts sent annually to the Board of Trade, or (as provided by Section 13 of the Deeds of Arrangement Act, 1914), at such times as may be prescribed.

Illustration

The following are the forms which have been prescribed in connection with the accounts of trustees under deeds of arrangement.

TRUSTEE'S TRADING ACCOUNT

RECEIPTS			PAYMENTS		
Date			Date		

LIST OF DIVIDENDS OR COMPOSITION

Surname	Christian Name	Amount of Claim	Amount of Dividend (or Composition)	
			Paid	Unpaid

TRUSTEE'S ACCOUNT OF RECEIPTS AND PAYMENTS

RECEIPTS			PAYMENTS			
Of whom received	Nature of Receipts	Amount	Date	To whom paid	Nature of Payments	Amount

§ 4. The Preparation of a Statement of Affairs of a Company in Compulsory Liquidation

Within fourteen days from the date of the winding-up order, or of the appointment of a provisional liquidator, a Statement of Affairs in the prescribed form must be submitted by the directors or secretary, or one of the chief officers of the company. If necessary, the official receiver may require some other employee of the company

competent to do so, to prepare the statement, or even an employee of a company which is an officer, *e.g.*, secretary, of the company in liquidation

The form of this statement is prescribed by the Companies (Winding-up) Rules, 1949, and is somewhat different from that used in bankruptcy, since it is designed to show not only the estimated surplus or deficiency as regards creditors of the company, but also the estimated surplus or deficiency so far as the members are concerned. The statement must be accompanied by the following schedules:

A. Assets not specifically pledged.

B. Secured creditors, and assets specifically pledged to them.

C. Preferential creditors.

D. Debenture holders secured by a floating charge.

E. Unsecured creditors.

F. Issued and called-up capital (Preference Shares).

G. Issued and called-up capital (Ordinary Shares).

H. Deficiency or Surplus Account.

In the case of a winding-up where the relevant date is after 30th June, 1948, the following debts are preferential (§ 319). For this purpose the expression 'the relevant date' means:

(i) in the case of a company ordered to be wound up compulsorily, the date of the appointment (or first appointment) of a provisional liquidator, or, if no such appointment was made, the date of the winding-up order, unless in either case the company had commenced to be wound up voluntarily before that date; and

(ii) in any other case the date of the passing of the resolution for the winding up of the company.

(*a*) The following rates and taxes:

(i) all local rates due from the company at the relevant date, and having become due and payable within twelve months next before that date;

(ii) all land tax, income tax, profits tax, excess profits levy or other assessed taxes assessed on the company up to the 5th April next before that date (including tax *due* for the period to 5th April although not yet assessed (*Gowers v. Walker*)), and not exceeding in the whole one year's assessment. (The Crown may select any one year's assessment; they are not confined to the year immediately preceding the relevant date);

(iii) the amount of any purchase tax due from the company at the relevant date, and having become due within twelve months next before that date.

(iv) any sums due at the relevant date by the company on account of tax deductions under P.A.Y.E. for the twelve months next before that date (*Finance Act*, 1952, § 30).

(v) any estate duty payable by a company in respect of assets of a company deemed to pass on a death by virtue of Section 46, Finance Act, 1940 (*Finance Act*, 1940, § 54).

(*b*) All wages or salary (whether or not earned wholly or in part by way of commission) of any clerk or servant in respect of services rendered to the company during four months next before the relevant date and all wages (whether payable for time or for piece work) of any workman or labourer in respect of services so rendered. Any remuneration in respect of a period of holiday or of absence from work through sickness or other good cause is deemed to be wages in respect of services rendered to the company during that period.

(*c*) Any sum ordered under the Reinstatement in Civil Employment Act, 1944, to be paid by way of compensation where the default by reason of which the order for compensation was made occurred before the relevant date, whether or not the order was made before that date.

The sum to which priority is to be given under paragraphs (*b*) and (*c*) above respectively is not, in the case of any one claimant to exceed £200. Where, however, a claimant under paragraph (*b*) is a labourer in husbandry who has entered into a contract for the payment of a portion of his wages in a lump sum at the end of the year of hiring, he has priority in respect of the whole of such sum, or a part thereof, as the court may decide to be due under the contract, proportionate to the time of service up to the relevant date.

(*d*) All accrued holiday remuneration becoming payable to any clerk, servant, workman or labourer (or in the case of his death to any other person in his right) on the termination of his employment before or by the effect of the winding-up order or resolution.

The expression 'accrued holiday remuneration' includes, all sums which, by virtue either of his contract of employment or of any enactment (including any order made or direction given under any Act), are payable to any person on account of the remuneration which would, in the ordinary course, have become payable to him in respect of a period of holiday had his employment with the company continued until he became entitled to be allowed the holiday.

References to remuneration in respect of a period of holiday include any sums which, if they had been paid, would have been treated for the purposes of the National Insurance Act, 1946, or any enactment repealed by that Act as remuneration in respect of that period.

(*e*) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with another company, all amounts due in respect of contributions payable during the twelve months next before the relevant date by the company as the employer of any person under the National Insurance Acts.

(*f*) Unless the company is being wound up voluntarily merely for the purposes of reconstruction or of amalgamation with another company, or unless the company has, at the commencement of the winding up, under such a contract with insurers as is mentioned in Section 7 of the Workmen's Compensation Act, 1925, rights capable of being transferred to and vested in the workman, all amounts due in respect of any compensation under the said Act, which have accrued before the relevant date in satisfaction of a right which arises or has arisen in respect of employment before the fifth day of July, 1948.

(*g*) the amount of any debt which, by virtue of subsection (5) of Section 3 of the Workmen's Compensation (Coal Mines) Act, 1934, is due from the company to an insurer in respect of a liability in respect of the satisfaction of a right falling within the last foregoing paragraph.

Where any compensation under the Workmen's Compensation Act, 1925, is a weekly payment, the amount due in respect thereof, for the purposes of paragraph (*f*) above, is to be taken to be the amount of the lump sum for which the weekly payment could, if redeemable, be redeemed if the employer made an application for that purpose under the said Act.

Where any payment has been made:

(*a*) to any clerk, servant, workman or labourer in the employment of a company, on account of wages or salary; or

(*b*) to any such clerk, servant, workman or labourer, or, in the case of his death, to any other person in his right, on account of accrued holiday remuneration;

out of money advanced by some person for that purpose, the person by whom the money was advanced has a right of priority in respect of the money so advanced and paid up to the amount by which the sum in respect of which the clerk, servant, workman or labourer, or other person in his right, would have been entitled to priority in the winding up has been diminished by reason of the payment having been made.

The foregoing debts:

(*a*) rank equally among themselves and are to be paid in full, unless the assets are insufficient to meet them, in which case they are to abate in equal proportions; and

(*b*) in the case of a company registered in England, so far as the assets of the company available for payment of general creditors are insufficient to meet them, have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

Subject to the retention of such sums as may be necessary for the costs and expenses of the winding up, the foregoing debts are to be discharged forthwith so far as the assets are sufficient to meet them, and in the case of the debts to which priority is given by paragraph (*e*) formal proof thereof is not required except in so far as is otherwise provided by general rules.

In the event of a landlord or other person distraining or having distrained on any goods or effects of the company within three months next before the date of a winding up order, the debts to which priority is given by this section are a first charge on the goods or effects so distrained on, or the proceeds of the sale thereof; but, in respect of any money paid under any such charge, the landlord or other person has the same rights of priority as the person to whom the payment is made.

Unpaid calls on shares are treated in the Statement of Affairs as an asset at the amount they are expected to realise, the balance being entered as a loss in the Deficiency Account. The nominal amount of unpaid capital liable to be called up is not shown as an asset, but is given as a note at the foot of the Statement of Affairs.

The Deficiency Account covers a period commencing on a date not less than three years before the date of the winding-up order, or, if the company was formed within the three years, the date of formation of the company. It sets out in detail all items contributing to the deficiency (or reducing the surplus) commencing with the excess (if any) of capital and liabilities over assets (*i.e.*, any debit balance on Profit and Loss Account) three years previously. From the total of these items is deducted the total of all items reducing the deficiency (or contributing to the surplus), and the balance represents the deficiency or surplus disclosed by the statement of affairs. A note is appended of the items taken into account in arriving at the amount of the net trading profits or losses shown in the account.

Illustration

From the following particulars prepare statement of affairs of the General Trading Company, Limited, as at 31st December, 1958, the date of the Winding-up Order:

	£
Land and Premises (book value £13,000) valued at	11,210
Secured Creditors holding First Mortgage on Land and Premises	8 090
Partly Secured Creditors holding Second Mortgage on Land and Premises	4 510
Unsecured Creditors	10,160
100 6% Mortgage Debentures of £100 each, carrying a floating charge on the assets, interest payable 30th June and 31st December, paid to 30th June, 1958	
Liabilities on Bills discounted	1,400
Of which it is expected to rank	420
Managing Director's Salary, owing for five months	200
Weekly Wages unpaid (4 weeks)	140
Debtors: Good	9,265
" Doubtful, estimated to produce 6s. 8d. in the £	2,940
" Bad	1,750
Bills Receivable: Good	320
Bank Overdraft	26
Cash in Hand	3
Stock (cost £15,000) valued at	11,000
Issued Capital:	
100 Founders' Shares of £1 each, 10s. called up.	
15,000 Ordinary Shares of £1 each, issued as fully paid.	
5,000 Preference Shares of £1 each, fully called up, on which there are Calls in arrear of £150, estimated to produce £100.	

The debit balance on Profit and Loss Account on 31st December, 1955, was £2,200. Net trading losses for the 3 years ended 31st December, 1958, after charging £600 depreciation, £1,800 interest on debentures and £6,000 directors' fees, and crediting £50 transfer fees and profit on sale of investments £120, were £8,848.

STATEMENT AS TO THE AFFAIRS OF

GENERAL TRADING COMPANY, LIMITED,

ON THE 31ST DECEMBER, 1958, THE DATE OF THE WINDING-UP ORDER SHOWING ASSETS AT ESTIMATED REALISABLE VALUES AND LIABILITIES EXPECTED TO RANK

ASSETS NOT SPECIFICALLY PLEDGED (as per List 'A')	Estimated Realisable Values £
Balance at Bank	
Cash in Hand	
Marketable Securities	
Bills Receivable	320
Trade Debtors	10,245
Loans and Advances	
Unpaid Calls	100
Stock in Trade	11,000
Work in Progress	
Freehold Property	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings, Utensils, etc. .	
Patents, Trade Marks, etc.	
Investments other than marketable securities	
Other property, *viz.*:	

ASSETS SPECIFICALLY PLEDGED (as per List 'B')	(*a*) Estimated Realisable Values	(*b*) Due to Secured Creditors	(*c*) Deficiency ranking as Unsecured (see next page)	Surplus carried to last column
	£	£	£	£
Freehold Property	11,210	12,600	1,390	—
	£11,210	£12,600	£1,390	£—

Estimated surplus from Assets specifically pledged .

ESTIMATED TOTAL ASSETS AVAILABLE FOR PREFERENTIAL CREDITORS, DEBENTURE HOLDERS SECURED BY A FLOATING CHARGE, AND UNSECURED CREDITORS* (carried forward to next page) .. £ 21,668

SUMMARY OF GROSS ASSETS

	(*d*) £
Gross realisable value of assets specifically pledged ..	11,210
Other Assets	21,668
GROSS ASSETS	£ 32,878

			£
	ESTIMATED TOTAL ASSETS AVAILABLE FOR PREFERENTIAL CREDITORS, DEBENTURE HOLDERS SECURED BY A FLOATING CHARGE, AND UNSECURED CREDITORS* (brought forward from preceding page)		21,668
(e) Gross Liabilities £	LIABILITIES (to be deducted from surplus or added to deficiency as the case may be)		
11,210	SECURED CREDITORS (as per List 'B') to extent to which claims are estimated to be covered by Assets specifically pledged (item (a) or (b) on preceding page, whichever is the less) .. .. (Insert in 'Gross Liabilities' column only.)		
140	PREFERENTIAL CREDITORS (as per List 'C')		140
	Estimated balance of assets available for Debenture Holders secured by a floating charge, and Unsecured Creditors*	£	21,528
10,300	DEBENTURE HOLDERS secured by a floating charge (as per List 'D')		10,300
	Estimated SURPLUS as regards Debenture Holders*	£	11,228
	UNSECURED CREDITORS (as per List 'E'):	£	
1,390	Estimated unsecured balance of claims of Creditors partly secured on specific assets, brought from preceding page (c)	1,390	
10,160	Trade Accounts	10,160	
	Bills Payable		
200	Outstanding Expenses	200	
26	Bank Overdraft	26	
	.. ..		
	Contingent Liabilities (State nature):		
420	Bills Discounted	420	12,196
	ESTIMATED DEFICIENCY AS REGARDS CREDITORS* being difference between:	£	
	GROSS ASSETS brought from preceding page (d) . ..	32,878	
	and GROSS LIABILITIES as per column (e)	33,846	
£33,846			968
	ISSUED AND CALLED-UP CAPITAL	£	
	5,000 preference shares of £1 each	5,000	
	£1 called-up (as per List 'F')		
	15,000 ordinary shares of £1 each	15,000	
	£1 called-up (as per List 'G')		
	100 founders' shares of £1 each		
	10s. called-up	50	
			20,050
	ESTIMATED DEFICIENCY AS REGARDS MEMBERS* (as per List 'H') ..	£	21,018

*These figures must be read subject to the following notes:

(1) (f) There is no unpaid capital liable to be called up *or*

(g) The nominal amount of unpaid capital liable to be called-up is £50, estimated to produce £50, which is charged in favour of Debenture Holders. Strike out *(f) or (g)*

(2) The estimates are subject to costs of the winding-up and to any surplus or deficiency on trading pending realisation of the Assets.

The period covered by this Account must commence on a date not less than three years before the date of the winding-up order (or the date directed by the official receiver) or, if the company has not been incorporated for the whole of that period, the date of formation of the company, unless the official receiver otherwise agrees.

			£
Items Contributing to Deficiency (or Reducing Surplus):			
1. Excess (if any) of Capital and Liabilities over Assets on the 31st December, 1955, as shown by Balance Sheet (copy annexed) ..			2,200
2. Net dividends and bonuses declared during the period from 19 to the date of the Statement			—
3. Net trading losses (after charging items shown in note below) for the same period ..			9,018
4. Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars or annex schedule) ..			
5. Estimated losses now written off or for which provision has been made for the purpose of preparing the Statement (give particulars or annex schedule) ..			9,970
6. Other items contributing to Deficiency or reducing Surplus:			
		£	21,188
Items Reducing Deficiency (or Contributing to Surplus):			
7. Excess (if any) of Assets over Capital and Liabilities on the 19 as shown on the Balance Sheet (copy annexed) ..			
8. Net trading profits (after charging items shown in note below) for the period from the 19 to the date of the Statement ..	—		
9. Profits and income other than trading profits during the same period – Transfer Fees ..	50		
Profit on Sales of Investments ..	120		
10. Other items reducing Deficiency or contributing to Surplus ..	—	170	170
..	—		
Deficiency/Surplus as shown by Statement ..			21,018

Note as to Net Trading Profits and Losses:

Particulars are to be inserted here (so far as applicable) of the items mentioned below, which are to be taken into account in arriving at the amount of net trading profits or losses shown in this Account:

	£
Provisions for depreciation, renewals, or diminution in value of fixed assets ..	600
Charges for United Kingdom income tax and other United Kingdom taxation on profits ..	—
Interest on debentures and other fixed loans ..	1,800
Payments to directors made by the company and required by law to be disclosed in the accounts ..	6,000
Exceptional or non-recurring expenditure:	
...	
	£ 8,400
Less: Exceptional or non-recurring receipts:	
..	
	£ 8,400
Balance, being other trading profits or losses ..	618
Net trading profits or losses as shown in Deficiency or Surplus Account above ..	£ 9,018

Signature

Dated 14th January, 1959

Schedule of Losses now written off

Land and Buildings ..	£1,790
Stock ..	4,000
Book Debts ..	3,710
Calls ..	50
Bills discounted ..	420
	£9,970

§ 5. The Accounts of a Liquidator in Compulsory Liquidation

These accounts are similar to those of a trustee in bankruptcy. The liquidator must keep a cash book in the prescribed form, containing columns for every class of receipt and payment.

The following is the form provided:

LIQUIDATOR' CASH K

CEIPTS

Date	Total	awr om nk	Debts Collecte	Property Realised	Receipts from Securities held by Creditors

PAYM

Voucher Nos. (in red)	Tota

PAY

Paid into B	Board of Trade and Court Fees	Law Costs of Petition	Law Costs after Winding-up Order	Remuneration of Manager and Liquidator	Official Receiver's Com. on Assets realised and amounts distributed in Dividend or paid to Contributories	Charges of Auctioneer, Accountant, Shorthand Writer, etc., as taxed	Notices in *Gazette* and Local Paper	Incidental Expenses including Possession	Preferential Creditors and Rent	Payments to Redeem Securities	Dividends Paid	Repayments to Contributories	Other Payments

At the expiration of six months from the date of the winding-up order, and every succeeding six months until his release, the liquidator must send to the Board of Trade a duplicate copy of the cash book for such period, together with the necessary vouchers, and copies of the certificate of audit of the committee of inspection. One copy of the cash book so required will be in the form shown above, the other copy being simply a summarised form without detailed columns.

If the liquidator carries on business for the company, he must keep a Trading Account, recording simply the cash receipts and payments. This account must be kept in the prescribed form, and the weekly totals of receipts and payments on Trading Account must be incorporated in the cash book.

The liquidator must transmit to the Board of Trade with his accounts a summary thereof in the prescribed form, copies of which are sent out to creditors and contributories.

At the date of application by the liquidator for release, he must prepare a summarised statement of receipts and payments in the prescribed form, showing the position of the company at that date.

Under Section 342, Companiies Act, 1948, if the winding-up has not been completed within one year, the liqudator must make the returns to the registrar required by the section in the prescribed form.

§ 6. The Accounts of a Liquidator in Voluntary Liquidation

Where it is proposed to wind up a company voluntarily, the directors (or a majority if there are more than two) may make a statutory declaration that they have made a full enquiry into the affairs of the company and have formed the opinion that the company will be able to pay its debts in full within such period, not exceeding twelve months, from the commencement of the winding-up as is stated in the declaration. Such a statement, to be effective, must be made within the five weeks preceding the date of the passing of the resolution for winding-up and be filed with the registrar of companies before that date, and must embody a statement of the company's assets and liabilities at the latest practicable date prior to the declaration. The winding-up will then be a 'members' voluntary winding-up'; if the declaration is not made, it will be 'a creditors' voluntary winding-up'. There are heavy penalties for making such a declaration without reasonable grounds; if the company does not pay or provide for its debts in full within the period stated in the declaration, it will be presumed that the directors did not have reasonable grounds for that opinion, unless the contrary is shown (§ 283, Companies Act, 1948).

The statement of assets and liabilities must be in the following form:

Statement as at . 19 showing Assets at estimated realisable values and Liabilities expected to rank

Assets and Liabilities	Estimated to realise or to rank for payment (to nearest £)
ASSETS:	£
Balance at Bank .	
Cash at Bank .	
Cash in Hand .	
Marketable Securities.	
Bills Receivable .	
Trade Debtors .	
Loans and Advances .	
Unpaid Calls .	
Stock in Trade .	
Work in Progress .	
Freehold Property	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings, Utensils, etc. ..	
Patents, Trade Marks, etc.	
Investments other than marketable securities	
Other property, *viz.*:	
Estimated realisable value of Assets	
LIABILITIES:	
Secured on specific assets, viz.:	
.. ..	
Secured by Floating Charge(s)	
Estimated Costs of Liquidation and other expenses including interest accruing until payment of debts in full	
Unsecured Creditors (amounts estimated to rank for payment): £	
Trade Accounts	
Bills Payable	
Accrued Expenses	
Other Liabilities:	
Contingent Liabilities:	
Estimated Surplus after paying Debts in full .. £	

Remarks:

If the liquidator is at any time of opinion that the company will not be able to pay its debts in full within the period stated in the above mentioned declaration, he must forthwith summon a meeting of creditors and lay before it a statement of the assets and liabilities in a form identical to that of the Statement of Affairs shown on pages 486-7, except that the date as at which the assets and liabilities are stated is left open, since the liquidator may have been continuing the company's business and have fresh assets and liabilities to disclose (Companies Act, 1948, Section 288).

In a creditors' voluntary winding-up, the company must summon a meeting of creditors for the day, or the day next following the day on which the resolution for winding-up is proposed to be passed. The directors must lay before that meeting a full statement of the company's affairs and a list of the creditors and their estimated claims (Section 293, Companies Act, 1948). No form of statement is laid down, but it can conveniently follow that shown on pages 486-7.

In any voluntary winding-up, the liquidator is required to keep an account of his receipts and payments.

If the liquidation continues for more than one year, the liquidator must summon a general meeting of the company at the end of the first year (unless a meeting under Section 288 of the Companies Act, 1948, was held within 3 months before the end of that year), and of each succeeding year from the commencement of the winding-up, or as soon thereafter as may be convenient, and lay before the meeting an account of his receipts and payments.

When the liquidation is finally completed, a general meeting must be summoned by the liquidator, and an account laid before it showing the way in which the property of the company has been disposed of.

The account must be in the following form:

NO. 110 (RULE 182)

No. of Company **The Companies Act, 1948**

LIQUIDATOR'S STATEMENT OF ACCOUNT (MEMBERS' OR CREDITORS' VOLUNTARY WINDING-UP)
(Pursuant to Sections 290 and 300)

Statement showing how the winding-up has been conducted and the property of the company has been disposed of

* Delete as necessary

Name of Company... .. *Limited (in liquidation)*

Presented by .

LIQUIDATOR'S STATEMENT OF ACCOUNT [MEMBERS] *[CREDITORS] VOLUNTARY WINDING-UP

Statement showing how the winding-up has been conducted and the property of the company has been disposed of

From 19 (Commencement of Winding-up) to 19 (Close of Winding-up)

	Statement of Assets and Liabilities	Receipts			Payments		
	£	£	s.				
Receipts:				Costs of Solicitor to Liquidator			
Cash at Bank ..				Other law costs			
Cash in Hand . .				Liquidator's remuneration: ..	£	s.	d.
Marketable Securities .				When applicable { . % on £ realised .			
Sundry Debtors . .				{ . % on £ distributed .			
Stock in Trade . .				By whom fixed			
Work in Progress .. .				Auctioneers' and valuers' charges ..			
Freehold Property .				Costs of possession and maintenance of estate			
Leasehold Property . .				Costs of notices in *Gazette* and local papers			
Plant and Machinery				Incidental Outlay			
Furniture, fittings, utensils, etc...				Total costs and charges . ..	£		
Patents, trade marks, etc. .					£	s.	d.
Investments other than marketable securities . ..				(i) Debenture holders:			
Surplus from securities ..				Payment of £ per £ debenture			
Unpaid calls at commencement of winding-up				Payment of £ per £ debenture			
Amounts received from calls on contributories made in the winding-up				Payment of £ per £ debenture			
Receipts per trading account .					£	s.	d.
Other property *viz.*:				(ii) *Creditors*			
				.. . * Preferential			
				......* Unsecured:			
				Dividend(s) of s. d. in £ on £			
Less				(The estimate of amount expected to rank for dividend was £ .)			
Payments to redeem securities				(iii) Returns to contributories:	£	s.	d.
Costs of execution ..				.. .s . . d. per £ . . † share .			
Payments per trading account				.. ..s. . d. per £ . .. † share			
Net realisations				s. d. per £ . † share			
				Balance			

(1) Assets, including.......... ....show in the statement of assets and liabilities and estimated to be of the value of £. have proved to be unrealisable.

(2) State amount paid into the Companies Liquidation Account in respect of :
(*a*) unclaimed dividends payable to creditors in the winding-up . . .. .. £
(*b*) other unclaimed distributions in the winding-up .. .. £
(*c*) moneys held by the company in trust in respect of dividends or other sums due before the commencement of the winding-up to any person as a member of the company.. .. .. .. £

(3) Add here any special remarks the Liquidator thinks desirable:

Dated this day of 19.....

(Signature of liquidator(s))
(address)

* State number. Preferential creditors need not be separately shown if all creditors have been paid in full

† State nominal value and class of share.

Returns to the registrar under Section 342, Companies Act, 1948, must be made by the liquidator if the winding-up is not completed within one year.

Illustration

The X Company Limited, went into voluntary liquidation on the 31st December, with preferential creditors £408, other unsecured creditors £3,375, and 6 per cent. debentures £4,000, secured by a floating charge on the undertaking, the interest on which was paid to 30th June.

The assets realised £7,255, being £4,200 from sale of stock, £3,030 from books debts and £25 cash in hand at the commencement of liquidation. The debentures were paid off on 30th June of the following year, and a first and final dividend distributed to creditors. Cost of liquidation amounted to £95 2s. 0d.

Prepare the liquidator's final Statement of Account for presentation to the shareholders, his remuneration being at the rate of 3 per cent. on the amount realised and 2 per cent. on the amount distributed to unsecured creditors. Ignore Income Tax.

THE X COMPANY, LIMITED (IN LIQUIDATION)
LIQUIDATOR'S STATEMENT OF ACCOUNT

RECEIPTS	£	s.	d.	£	s.	d.	PAYMENTS	£	s.	d.	£	s.	d.
To Realisation of Assets:							By Costs				95	2	0
Cash..	25	0	0				„ Liquidator's Remuneration:						
Stock .. .	4,200	0	0				3% on £7,230 realised	216	18	0			
Book Debts .. .	3,030	0	0				2% on £2,250 distributed	45	0	0			
				7,255	0	0					261	18	0
							„ Preferential Creditors .				408	0	0
							„ Debenture-holders ..	4,000	0	0			
							„ Interest to date of payment.	240	0	0			
											4,240	0	0
							„ Unsecured Creditors: First and Final Dividend of 13s 4d in the £ on £3,375				2,250	0	0
				£7,255	0	0					£7,255	0	0

Note.

The first part of the liquidator's remuneration will be calculated on the amounts *realised* by him. He will not, therefore, be entitled to any percentage on the cash in hand at the commencement of the liquidation. His remuneration will, however, be calculated on the *gross* amounts realised before deducting expenses.

Rule 159 of the Winding-Up Rules, which applies only to a winding-up by the court, provides that this percentage shall be on the amount realised 'after deducting the sums (if any) paid to secured creditors (other than debenture holders) out of the proceeds of their securities'.

Applying this principle to this example, the liquidator will be entitled to remuneration on the full £7,230, before deducting the amounts paid to the debenture holders.

The second portion of the liquidator's remuneration is computed on the amount distributed to unsecured creditors.

The cash to be divided between the liquidator and the unsecured creditors amounts to £2,295. Since the commission is to be 2% on the amount distributed (*i.e.*, *after* deducting such commission), it will be equal to $\frac{2}{102}$ of £2,295, *viz.*, £45, leaving £2,250 (equivalent to a dividend of 13s. 4d. in the £) available for the unsecured creditors.

§ 7. Return to Shareholders

In the event of some shares being fully paid up and others only partly paid up, it will become necessary for the liquidator to adjust the rights of the contributories between themselves, and this may involve the making of a call on those shareholders whose

shares are only partly paid up. It is essential that the amounts finally contributed by shareholders in any one class should be equal as between themselves.

If a surplus remains after all costs and liabilities have been discharged, such surplus must be distributed between the shareholders according to their rights under the memorandum and articles of association.

Shares which have preference as to repayment of capital should be paid off first (if necessary out of the proceeds of a call made on shares of an inferior degree); if there remains a surplus after all the shareholders have received the nominal amount of their shares, it would appear from the decision of the House of Lords in *Scottish Insurance Corporation Ltd.* v. *Wilsons and Clyde Coal Co., Ltd.* (1949), which overruled the previous decision in *Re William Metcalfe & Sons, Ltd.* that unless on a true construction of the articles the preference shareholders are entitled to share in such surplus, it belongs to the ordinary shareholders. If the articles give the preference shareholders the rights to priority as to the return of capital, the presumption is that they are not entitled to any further share in the assets.

In regard to any arrears of preference dividend, the basic rule is that in the absence of some provision in the articles to the contrary preference shareholders have no right to arrears of dividend unless declared before the commencement of the winding up (*Re Crichton's Oil Co. Ltd.* (1902) 2 Ch. 86). It would seem, however, that any indication that the shares are to be preferential as to dividend on a winding-up may be sufficient to exclude this rule. In *Re E. W. Savory, Ltd.* (1951), 2 All E.R. 1036, where the articles stated that 'the preference shares . . . shall confer on the holders the right to a fixed cumulative preference dividend at the rate of 6 per cent per annum on the capital paid up thereon and shall rank both as regards dividends and capital in priority to all other shares, both present and future' it was held that the preference shareholders were entitled to arrears of dividend on winding-up although no dividends had been declared. The arrears are calculated up to the commencement of the winding-up and not to the date of repayment of capital. Income tax is not deductible from arrears of preference dividends payable in a winding-up (*Re Dominion Tar and Chemical Co. Ltd.* (1929), 2 Ch. 387).

Illustration (1)

The capital of The Motor Company, Limited (in voluntary liquidation), consists of:

2,000 Preference Shares of £5 each, fully paid up.
8,000 Ordinary Shares of £5 each, fully paid up.
6,000 Ordinary Shares of £5 each, £4 per share paid up.
2,000 Deferred Shares of £5 each, £4 per share paid up.

Under the articles of association, the preference shares have priority as to repayment of capital over the ordinary shares, and the ordinary shares priority over the deferred shares.

The costs of liquidation, including the liquidator's remuneration, amounted to £700, and the creditors to £8,900.

The assets realised £18,700. The call made by the liquidator on the deferred shareholders for the adjustment of the rights of shareholders *inter se* was fully paid. A call of 10s. per share was made on the partly-paid ordinary shareholders, which was duly paid, with the exception of that on 200 Shares, which was irrecoverable.

Prepare the liquidator's final Statement of Account.

THE MOTOR COMPANY, LIMITED (IN LIQUIDATION)
LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

		£			£
To Realisation of Assets		18,700	By Costs of Liquidation .		700
,, Proceeds of Call of £1 per Share on 2,000 Deferred Shares of £5 each ..		2,000	,, Creditors paid in full .		8,900
,, Call of 10s. per Share on 6,000 Ordinary Shares of £5 each, to make them £4 10s. paid	3,000		,, Return to Shareholders:		
Less Call unpaid on 200 Shares ..	100		£5 per Share on 2,000 Preference Shares of £5 each, being return in full . .	10,000	
		2,900	10s. per Share on 8,000 Ordinary Shares of £5 each, leaving £4 10s. per Share paid	4,000	
		£23,600			

Notes.

(1) The 200 shares in respect of which the call is irrecoverable will be forfeited.

(2) The call from the holders of the partly-paid ordinary shares makes the partly-paid shares £4 10s. 0d. paid, and the proceeds must be applied in payment of 10s. per share to holders of fully-paid ordinary shares, which leaves all the ordinary shares £4 10s. 0d. paid.

There would be no point in calling up 15s. per share on the partly-paid shares and then paying back 5s. The effect is obtained by merely calling up 10s. per share.

Illustration (2)

A company having the following issued share capital went into voluntary liquidation:

40,000 6 per cent. preference shares of £1 each, 15s. paid.
2,000,000 ordinary shares of 2s. each, 9d. paid.

The articles gave the preference shareholders a preferential right to dividends, but were silent as to repayment of capital.

The assets were realised, and the liquidator's expenses and remuneration and the preferential creditors paid. It was then found that the remaining balance was insufficient by the sum of £3,000 to pay the unsecured creditors.

Advise the liquidator as to his procedure in raising calls on the members.

The liquidator should be advised as follows:

The shareholders will all rank *pari passu*, and it will therefore be necessary to call up on some and repay on others. Care must be taken to compute the exact amounts in each case, since it would be inexpedient to make unnecessary calls on members entitled to a repayment.

Ascertain first what would be available if all the uncalled capital were called up. This would produce:

5s. per share on 40,000 £1 preference shares	£10,000
1s. 3d. ,, ,, 2,000,000 2s. ordinary shares	125,000
	£135,000
Deduct amount to meet balance of creditors	3,000
Leaving available for repayment to members	£132,000

Since the paid-up capital would then be:

40,000 £1 preference shares	£40,000
2,000,000 2s. ordinary shares	200,000
	£240,000

where he ceases to act, during the period from the end of the period to which the last preceding abstract related up to the date of his so ceasing, and the aggregate amounts of his receipts and payments during all preceding periods since his appointment.

Where the receiver is appointed under the powers contained in any instrument, for references in the preceding paragraph to the court, references to the Board of Trade should be substituted.

Where the receiver is appointed under the powers contained in any instrument and is not a receiver of the whole or substantially the whole of the property of the company under a floating charge, the only requirement is that abstracts must be sent to the registrar within one month of the receiver's appointment, and thereafter at intervals of six months, and within one month after the receiver ceases to act. This applies to receivers appointed out of court under a fixed charge.

Every receiver or manager who makes default in complying with the provisions of this section is liable to a fine not exceeding £5 for every day during which the default continues.

The following is the form of accounts prescribed:

Number of Certificate .. FORM NO

THE COMPANIES ACT, 1948

[No Registration Fee Payable]

RECEIVER OR MANAGER'S ABSTRACT OF RECEIPTS AND PAYMENTS

(Pursuant to Section 372 (2) and 374 (1) of the Companies Act, 1948)

Name of Company .. Limited

Name and Address of Receiver or Manager

Date and description of instrument under which Receiver or Manager is appointed

Period covered by the Abstract { *From* . / *To* .

Presented by

ABSTRACT

RECEIPTS	£	s.	d.	PAYMENTS	£	s.	d

Signature.

Dated the............. day of ... .19....

MISCELLANEOUS ACCOUNTS

§ 1. Hire-Purchase Agreements and Agreements to pay by Instalments

A hire-purchase agreement must be distinguished from an agreement to pay by instalments. In the former, the property in the goods does not pass until the final instalment has been paid, or some other condition in the contract has been complied with, and if default in the payment of any instalment is made, the person supplying the goods can, normally, demand the return of the goods. In the latter case, however, the property in the goods passes immediately on delivery thereof, and in the event of default in payment of any of the instalments, the goods cannot be recovered by the vendor, but an action can be brought for the amount of the purchase price unpaid. Many modern hire-purchase agreements are drawn up so as to preserve remedies against the person as well as against the goods, but a discussion of such agreements is beyond the scope of this work.

(a) Hire-Purchase Agreements

The methods of recording hire-purchase transactions vary according to the nature of the goods, the volume of transactions, the size of the business, and the facts generally. Set out below are the more usual methods which can be adapted to fit the circumstances.

Where the goods are of considerable value, the following method can conveniently be adopted:

(1) BUYER'S BOOKS: Ascertain the cash price of the goods and the rate of interest which is added to arrive at the hire-purchase price. Debit the Asset Account and credit the Vendor's Account with such cash price. Debit the Vendor's Account and credit Cash with the instalments paid. Debit Interest Account and credit the Vendor's Account with the accruing interest on the balance at each due date for payment of an instalment.

The Asset Account is then depreciated in the usual manner. In each Balance Sheet, the asset will appear at its depreciated value, less the amount standing to the credit of the vendor, thus showing the equity in the asset which has been paid for to date. The amount shown in the Balance Sheet is thus the depreciated present value of the option to purchase, and is a proper amount to include in the Balance Sheet in view of the intention to complete the purchase in due course.

Illustration (1)

A company acquires wagons on the hire-purchase system over a term of two years, commencing 1st January. The instalments of £400 each are payable half-yearly. The present cash value of the wagons is £1,487, and the wagon company compute interest at the rate of 6 per cent. per annum, working on half-yearly rests. Show the ledger accounts in the books of the buyers writing off depreciation at 7½ per cent.

WAGONS ACCOUNT

			£ s. d.				£ s. d.
19 .				19			
Jan.	1	To Wagon Company—Cash Value	1,487 0 0	Dec.	31	By Depreciation Account	111 10 6
						„ Balance c/d.	1,375 9 6
			£1,487 0 0				£1,487 0 0
Jan	1	To Balance b/d. ..	1,375 9 6	Dec.	31	By Depreciation Account	103 3 3
						„ Balance c/d.	1,272 6 3
			£1,375 9 6				£1,375 9 6
Jan	1	To Balance b/d. ...	1,272 6 3				

VENDOR'S ACCOUNT

			£ s. d.				£ s. d.
19				19			
June	30	To Cash	400 0 0	Jan.	1	By Wagons Account Cash Value	1,487 0 0
		„ Balance c/d.	1,131 12 2	June	30	„ Interest Account	44 12 2
			£1,531 12 2				£1,531 12 2
Dec.	31	To Cash	400 0 0	July	1	By Balance b/d	1,131 12 2
		„ Balance c/d.	765 11 2	Dec.	31	„ Interest Account	33 19 0
			£1,165 11 2				£1,165 11 2
June	30	To Cash ..	400 0 0	Jan.	1	By Balance b/d.	765 11 2
		„ Balance c/d.	388 10 6	June	30	„ Interest Account	22 19 4
			£788 10 6				£788 10 6
Dec.	31	To Cash	400 0 0	July	1	By Balance b/d.	388 10 6
				Dec.	31	„ Interest Account	11 9 6
			£400 0 0				£400 0 0

NOTE.—(i) A small adjustment of the interest on the last instalment is made necessary to balance
(ii) For simplicity depreciation has been shown as a credit to the Wagons Account. In practice, of course, the credit would be to a Provision for Depreciation of Wagons Account

In the Balance Sheet, the items would appear as follows:

First year:

Wagons at cost, less depreciation	£1,375 9 6	
Less Hire purchase instalments not yet due (present value)	765 11 2	
		£609 18 4

Second year :

Wagons at cost, *less* depreciation	£1,272 6 3

An alternative method is to make no entry in respect of the hire-purchase until the first payment becomes due, when a journal entry is passed through the books crediting the vendor with the full amount of the payment, and debiting an Interest on Hire-Purchase Account with the proportion thereof which, on the assumption that the agreement will eventually be completed, represents the cost of hiring the goods during the period covered by the payment. The difference between the total of each payment and the amount thereof debited to Interest Account will represent the proportion of the asset actually purchased in respect of that payment, presuming, as in the case of interest, that the agreement will ultimately be fulfilled. The apportionment of each instalment as between interest and capital will be calculated as follows:

The buyer should ascertain what it would cost to purchase the article for cash;

this figure will represent the present cash value, and will form the basis for the calculation of interest. He will also ascertain the rate of interest which is being charged by the seller in respect of the hire. As regards the first instalment, interest at the ascertained rate will be calculated on the present value of the article for the period of the rest. The figure thus arrived at will represent the charge to revenue, and the balance of the instalment will be treated as capital. In the second instalment, interest at the fixed rate will be calculated on the cash value of the article, less the proportion of the first instalment which was treated as capital. All further instalments will be dealt with in a similar manner. After the last instalment has been paid, the balance on the Asset Account will be found to equal the original cash value; but as this figure will be in excess of the true value of the asset at that date, provision for depreciation should have been made during the term of the agreement, the calculation being based on the cash value, and not on the amounts paid.

This method gives the same ultimate result as the first, but is more cumbersome to operate, as memorandum computations are required to arrive at the figures, whereas under the first method the accounts themselves contain the required information.

Illustration (2)

A company acquires wagons on the hire-purchase system over a term of two years, commencing 1st January. The instalments of £400 each are payable half-yearly. The present cash value of the wagons is £1,487, and the Wagon Company compute interest at the rate of 6 per cent. per annum, working on half-yearly rests.

Make the necessary journal entries to record these transactions in the books of the purchasing company, distinguishing between capital and revenue.

			s. d.	£ s. d.
June 30	Sundries			
	To Wagon Co.			400 0 0
	Wagon Account		355 7 10	
	Wagon Hire Account (6% for 6 months on £1,487)		44 12 2	
Dec. 31	Sundries—	Dr.		
	To Wagon Co.			400 0 0
	Wagon Account		366 1 0	
	Wagon Hire Account (6% for 6 months on £1,131 12s. 2d.)		33 19 0	
June 30	Sundries—	Dr.		
	To Wagon Co.			400 0 0
	Wagon Account		377 0 8	
	Wagon Hire Account (6% for 6 months on £765 11s. 2d.)		22 19 4	
Dec. 31	Sundries—	Dr.		
	To Wagon Co.			400 0 0
	Wagon Account		388 10 6	
	Wagon Hire Account (6% for 6 months on £388 10s. 6d.)		11 9 6	

A third method of recording the transactions is to debit the Asset Account with the cash value, credit the vendor with the total amount of the instalments, and debit the difference, representing the *total* interest, to an Interest Suspense Account. The instalments, as paid, are debited to the Vendor's Account, and the interest accrued is computed and transferred from the Suspense Account to Interest Account.

For Balance Sheet purposes, the balance on the Interest Suspense Account is deducted from the balance on the Vendor's Account, and the net result deducted from the balance of the Asset Account.

(2) SELLER'S BOOKS:

The seller should keep a special sales day book for all sales under hire-purchase agreements, and enter therein full particulars of the terms. The amounts extended in this book should be the present cash value of each sale, which should be debited to the buyer and credited to Sales Account. As each instalment falls due, an entry should be passed through a special interest journal, debiting the customer with interest calculated upon the balance of the account. The total of this special journal will be posted periodically to the credit of Interest Account. It will be seen that by this method the seller takes credit through the Sales Account for profit equal to that which he would have made had he sold the articles in question for cash; and as regards the interest, he takes credit for a proportionate amount as each instalment becomes due.

Alternatively, the buyer may be debited with the total hire-purchase price, the excess of this figure over the cash price, representing interest, being credited to an Interest Suspense Account, from which it will be transferred to Interest Receivable Account as it accrues due. The ultimate result is, of course, the same.

Under the systems described above credit is taken for the gross profit on the whole transaction in the accounting period in which the agreement is entered into, only the interest being deferred until earned.

It may, however, be considered that as the sale is not completed until the whole of the instalments have been paid, the profit on the transaction should be spread over the period of the contract, the balance of the cash price outstanding from time to time being regarded, not as an amount owing by a debtor, but as stock out on hire. If this view is taken provision should be made, when preparing the final accounts, of a sum equal to the proportion of the balances on hirers' accounts representing unrealised profit. The provision should be adjusted to the requisite amount at the end of each year, in the same way as a provision for bad debts, and deducted from the total of the hirers' accounts, the balance being shown in the Balance Sheet not as debtors but as stock out on hire.

In any event, as the seller may have to take the goods back should the buyer default in payment of any instalments, provision should be made against possible loss arising from such a contingency.

Illustration (3)

P. White enters into a hire-purchase agreement with Messrs. A, B & Co., extending over a period of two years from 1st January.

P. White agrees to pay half-yearly instalments of £20 each. The present cash value of the goods is £74 7s. 0d., and the interest charged is at the rate of 6 per cent. per annum.

Show P. White's Account in the books of Messrs. A, B & Co.

P. WHITE

Agreement No. 72 (four half-yearly payments of £20)

			£ s. d.				£ s d
Jan. 1		To Sales Account	74 7 0	June 30		By Cash ...	20 0 0
June 30		„ Interest Account	2 4 7			„ Balance c/d.	56 11 7
			£76 11 7				£76 11 7
July 1		To Balance b/d.	56 11 7	Dec. 31		By Cash . .	20 0 0
Dec. 31		„ Interest Account	1 13 10			„ Balance c/d. ..	38 5 5
			£58 5 5				£58 5 5
Jan. 1		To Balance b/d. .	38 5 5	June 30		By Cash .	20 0 0
June 30		„ Interest Account	1 2 11			„ Balance c/d.	19 8 4
			£39 8 4				£39 8 4
July 1		To Balance b/d. .	19 8 4	Dec. 31		By Cash	20 0 0
Dec. 31		„ Interest Account	11 8				
			£20 0 0				£20 0 0

In the above example, assuming that A.B & Co. make up their accounts to 31st December each year, and that a gross profit of $33\frac{1}{3}$ per cent. is included in the cash price of the article sold, in order that the profit on the transaction may be spread over the period of the instalments a provision of one-third of £38 5s. 5d. = £12 15s. 2d. should be made in respect of unrealised profit on this transaction at the end of the first year, by debiting Profit and Loss Account and crediting Provision for Unrealised Profit Account. The amount so provided would be transferred from the Provision Account to the credit of Profit and Loss Account at the end of the second year when the profit had been realised.

In practice, as has already been stated, the provision would be calculated on the total of the balances outstanding on all hire-purchase contracts, and would be adjusted up or down at the end of each year by a transfer to Profit and Loss Account of such an amount as will leave a balance on the Provision Account equal to the unrealised profit included in the balances on all hire-purchasers' accounts at the year end.

In cases where the calculation of the exact interest accruing each year cannot conveniently be computed separately for each item, owing to the number of transactions or the great variations in their nature and terms, it is sometimes convenient to approximate the interest to be charged each year by taking an ascertained percentage of the total interest for all contracts entered into in the year. In this case an Interest Suspense Account will be raised for each year, to which the total interest will be credited. The ascertained percentage (found by computing the average interest earned on an average contract) will be written off at the end of each year that the contract is outstanding; the percentage will, of course, be at its highest in the first year, and will decrease as the years go on, since the principal is being repaid.

Illustration (4)

A hire-purchase agreement for the sale of an asset provided that the first payment of £25 be made six months after the date of the agreement, and five subsequent payments of £25 at

half-yearly intervals thereafter. Interest was computed at 5% per annum in arriving at the price.

The following table indicates how the interest can be worked out 'backwards'. Interest at $2\frac{1}{2}$% per half year is $\frac{2\frac{1}{2}}{102\frac{1}{2}} = \frac{1}{41}$ of the balance at the beginning of each half year, plus such interest (which must equal the closing balance plus the instalment for the half-year which is credited before arriving at such balance). The table can thus be constructed as follows:

Half-year.	Final Balance.	Instalment.	Total.	Interest included therein		Opening Balance.
	£ s. d.	£ s. d.	£ s. d.		£ s. d.	£ s. d.
6	nil	25 0 0	25 0 0	$\frac{1}{41}$ of £25 0 0	12 2	24 7 10
5	24 7 10	25 0 0	49 7 10	$\frac{1}{41}$ of £49 7 10 ...	1 4 1	48 3 9
4	48 3 9	25 0 0	73 3 9	$\frac{1}{41}$ of £73 3 9	1 15 8	71 8 1
3	71 8 1	25 0 0	96 8 1	$\frac{1}{41}$ of £96 8 1	2 7 0	94 1 1
2	94 1 1	25 0 0	119 1 1	$\frac{1}{41}$ of £119 1 1	2 18 1	116 3 0
1	116 3 0	25 0 0	141 3 0	$\frac{1}{41}$ of £141 3 0	3 8 10	137 14 2

The cash price of the asset is therefore £137 14s. 2d. as can be proved by writing up the purchaser's account in the form explained earlier.

Half year.		£ s. d.	Half year.		£ s. d.
1	To H.-P. Sales—Cash Price	137 14 2	1	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$%	3 8 10		„ Balance c/d	116 3 0
		£141 3 0			£141 3 0
2	To Balance b/d. ..	116 3 0	2	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$%	2 18 1		„ Balance c/d	94 1 1
		£119 1 1			£119 1 1
3	To Balance b/d.	94 1 1	3	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$%	2 7 0		„ Balance c/d.	71 8 1
		£96 8 1			£96 8 1
4	To Balance b/d. .	71 8 1	4	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$%	1 15 8		„ Balance c/d.	48 3 9
		£73 3 9			£73 3 9
5	To Balance b/d.	48 3 9	5	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$%	1 4 1		„ Balance c/d	24 7 10
		£49 7 10			£49 7 10
6	To Balance b/d. ...	24 7 10	6	By Cash	25 0 0
	„ Interest $2\frac{1}{2}$% (say)	12 2			
		£25 0 0			£25 0 0

In practice the interest would be computed actuarially.

It will be seen that the interest arises as follows:

		£ s. d.	%
Over the first year of the contract	£3 8 10 + £2 18 1 =	6 6 11	51·63
„ „ second „ „ „	£2 7 0 + £1 15 8 =	4 2 8	33·62
„ „ third „ „ „	£1 4 1 + 12 2 =	1 16 3	14·75
		£12 5 10	100%

If the accounts of the business were made up to 31st December in each year, and all contracts entered into on the first day of the accounting period, i.e., 1st January, assuming

the foregoing to be a representative contract, the above percentages of the total interest would be earned in the three accounting periods. In practice, however, contracts will begin on various dates, and the average date should be ascertained, *e.g.*, by taking the average due date of the monthly sales. If the average date were 1st July, only half the first year's interest would be earned in the first accounting period, and the percentages earned could be distributed as follows:

				%
First accounting period	½ of 51·63%	...		25·82
Second „ „	do.	...	25·81	
	plus ½ of 33.62%	...	16·81	
				42·62
Third	do.	...	16·81	
	plus ½ of 14·75%	...	7·38	
				24·19
Fourth „	do.	...		7·37
				100 %

Alternatively, the computation could be made by reference to the actual interest earned in each period.

A separate Interest Suspense Account will be opened for each financial year, to which will be credited the interest included in all contracts entered into in the year, the Purchaser's. Account being debited with the hire price and Sales Account credited with the cash price.

Applying this method to the example, and assuming the sale to take place at the beginning of the first financial period, the accounts would appear as follows:

H. P. SALES

Half-year.		£ s. d.	Half-year.		£ s. d.
1	To Trading Account	137 14 2	1	By Purchaser	137 14 2

PURCHASER

		£ s. d.	£ s. d.			£ s. d
1	To Sales	137 14 2		1	By Cash	25 0 0
	„ Interest Suspense Account	12 5 10		2	„ „	25 0 0
			150 0 0	3	„ „	25 0 0
				4	„ „	25 0 0
				5	„ „	25 0 0
				6	„ „	25 0 0
					„ „	

LST SUSPENSE ACCOUNT

Year			£ s. d.	Year.		£ s. d.
1	Profit and Loss Account	51·63%	6 6 11	1	By Purchaser	12 5 10
	do.	33·62%	4 2 8			
	do.	14·75%	1 16 3			

What is true of one account is obviously true of the accounts as a whole, provided the average date is taken. At any Balance Sheet date, there will always be three Suspense Accounts open, *e.g.*, the contracts entered into in 1955 will extend into 1958, and in the 1957 Balance Sheet will appear balances on the Suspense Accounts for 1955, 1956 and 1957.

In this illustration half-yearly payments have been taken; the same principles apply to monthly or quarterly payments.

In the buyer's books, it may be convenient to write off the interest on a similar basis.

The following alternative method is frequently adopted by hire-purchase traders, particularly where the volume of hire-purchase transactions is considerable. The personal accounts are treated as memorandum accounts, totals only being recorded in the financial books. The memorandum books comprise a hire purchase day book and hire-purchase personal ledger. The former is ruled with columns to show No. and date of agreement, name and address of hire-purchaser, cost and selling prices of the goods and the amount of the deposit and the number and amount of the instalments payable. Particulars are recorded in this book as the agreements are entered into.

Periodically, the total of the cost price column of the hire-purchase day book is debited to a Stock out on Hire Account and credited to General Trading Account, thus transferring therefrom the cost of goods sent out on hire-purchase.

The personal accounts in the memorandum ledger are debited with the selling price of the goods sent out, and credited with the cash received from the purchasers, the cash book being debited.

So far the only entries which have been made in the *financial* books are the debit to Stock out on Hire Account, the credit to General Trading Account in respect of the cost price of the goods sent out on hire contracts and the debits in the cash book for the deposits and instalments received. Periodically the total of the amounts received is credited to the Stock out on Hire Account, thus completing the double entry in the financial books for the cash realised

It will be seen that the Stock out on Hire Account is, in effect, a Hire-purchase Trading Account, which has been debited with the cost price of all goods forming the subject of hire-purchase contracts, and credited with the cash actually received in respect thereof, representing realised sales. To ascertain the profit on the hire contract for the period it will now be necessary to credit the account with the equivalent of the closing stock, viz., the *cost* price of the instalments not yet due on all uncompleted hire contracts, in respect of which the cost price of the goods has been debited to the Stock on Hire Account. This figure is found by computing, in respect of each contract, the proportion of the cost price of the goods which the total amount of the instalments still outstanding bears to the total amount payable under the contract. Thus, if the cost price of the goods forming the subject of a contract were £130, and the total sale price £200, payable by an initial deposit of £20 and 18 instalments of £10 each, of which 10 had been paid, leaving £80, not yet due, the outstanding instalments would be valued and brought into account as stock out on hire at $\frac{80}{200}$ of £130 = £52.

When a contract is broken by the purchaser making default in the payment of instalments, so that the goods have to be taken back by the seller, the Stock out on Hire Account should be credited, and a Stock Returned from Hire Account debited with the cost price (computed as above) of the instalments outstanding at the date

on which the goods were returned. The Stock Returned from Hire Account will, at the close of the accounting period, be transferred to the debit of Trading Account in the same way as sales returns.

Such a system is convenient where the transactions are numerous and by its use detailed calculations in respect of each individual contract are avoided. By this method, not only the interest, but also the true gross profit, is spread over all the instalments, the proportion taken as earned being that on the instalments received or due.

Illustration (5)

STOCK ON HIRE ACCOUNT

			£			£
Jan. 1	To Cost Value of Stock in hand of Customers b/f.		3,000	Dec. 31	By Cash, Amounts paid under Hire Purchase Agreements during year	13,000
Dec. 31	" Cost of Stock sent out on Hire Purchase during the year		8,000		" Cost value of Stock in hands of Hire Purchasers c/f. . ..	4,000
	" Profit and Loss Account: transfer of profit for year		6,000			
			£17,000			£17,000
Jan. 1	To Balance b/d.		4,000			

NOTES.—(1) The opening balance of £3,000 represents the cost value of the outstanding instalments on hire purchase contracts at 1st January brought forward from the preceding year.

(2) The figure of £8,000 debited to the account comprises the total of the cost price column of the hire purchase day book for the year.

(3) The closing stock of £4,000 is ascertained by reducing to cost the instalments not yet due on hire purchase contracts at 31st December.

The system described above is frequently modified in many details. One of the most important methods, whereby the whole of the accounts are contained in the financial books proper as part of the double entry, is dealt with hereunder.

Illustration (6)

To make the example clear, a new business is assumed. During the period, the following sales on hire purchases were made: to A, a piano costing £80, sold for £120, payable by a deposit of £12 and 36 instalments of £3 each ; to B, a suite costing £50, sold for £100 payable by a deposit of £10 and 45 instalments of £2 each; and to C a radiogram, costing £60, sold for £80 payable by a deposit of £8 and 9 instalments of £8 each. A had paid the deposit and 7 instalments; B the deposit and 9 instalments, and C the deposit and 2 instalments, one instalment being due from C but unpaid. Ordinary sales amounted to £8,000, total purchases to £6,690, and stock in hand to £500. Write up the accounts for the period and prepare the Hire Purchase Trading Account and the General Trading Account.

HIRE PURCHASE DAY BOOK

No.	Date.	Name and Address	Article.	Folio.	Hire Purchase Price.	Cost Price.	Amount of deposit	No. of Instalments.	Amount of each Instalment.	Remarks.
					£	£	£			
		A	Piano ...		120	80	12	36	£3	
		B	Suite ...		100	50	10	45	£2	
		C	Radiogram		80	60		9	£8	
					£300	£190	£30			

HIRE PURCHASE PERSONAL LEDGER

	£		£
To Piano	120	By Cash	12
			3
			3
			3
			3
			3
			3
			3
		„ Balance c/d.	87
	£120		£120
To Balance b/d.	87		

	£		£
To Suite	100	By Cash	
			72
	£100		£100
To Balance b/d.			

C

	£		£
To Radiogram	80	By Cash	8
			8
			8
		„ Balance c/d.—	
		Instalment due	8
		Instalments not due	48
	£80		
To Balance b/d —			
Instalment due	8		
Instalments not due	48		

SCHEDULE OF CLOSING BALANCES

	Amount Due	Amount Not due	Sale Price	Cost Price	Proportion not due	Cost Price of Instalments Not due
	£	£	£	£	£	£
A		87	120	80	87/120	58
B		72	100	50	72/100	36
C	8	48	80	60	48/80	36
	£8	£207	£300			£130

HIRE PURCHASE TRADING ACCOUNT

	£		£
To General Trading Account— Cost price of articles sold on hire purchase during period	190	By Hire Purchase Deposits and Instalments for period	93
„ Gross Profit carried to Profit and Loss Account	33	„ Instalments not due reduced to cost, being stock out on hire purchase . ..	130
	£223		£223
To Stock out on hire purchase b/d.	130		

HIRE PURCHASE SALES ACCOUNT

	£		£
To Hire Purchase Trading Account, Amount due for period	93	By Sundry Hire Purchasers	300
„ Balance, being instalments not due, c/d.	207		
	£300		£300
		By Balance b/d.	207

It will be observed that a provision is carried forward on the Hire Purchase Sales Account equal to the debtors for instalments not due. For Balance Sheet purposes, this is deducted from the hire purchase debtors, leaving only £8, the instalment due, to appear as a debtor.

The Stock out on Hire Purchase appears as an asset on the balance sheet.

GENERAL TRADING ACCOUNT

	£		£
To Purchases	6,690	By Sales	8,000
Less Transferred to Hire Purchase Trading Account	190	„ Stock	500
	6,500		
„ Gross Profit	2,000		
	£8,500		£8,500

By eliminating the goods sold on hire purchase in the manner shown, this account shows the true gross profit on ordinary sales.

Sometimes the two Trading Accounts are combined, but they are better separated.

Hire Purchase Finance

Frequently retailers do not carry the risk of their own hire-purchase contracts, but assign them to finance companies which are engaged solely in financing such transactions. The finance company to whom the benefit of a contract is assigned pays the trader the whole or the major part of the contract price (subject to a deduction for its charges) and collects the instalments, as they become due, from the hire purchaser. The trader debits cash and credits his Trading Account with the sum received from the finance company and thus treats the transaction as a completed sale, but provision should be made for the contingency of a loss being sustained by the hirer failing to pay the instalments, in which event the trader would have to indemnify the finance company and take the goods back.

In other cases the manufacturer of the article takes over the contract by crediting the trader with the amount of the hire-purchase price, less the deposit (if any) paid by the hire-purchaser. In such a case the debit will be to the manufacturer's account, instead of to cash, thus reducing the liability of the trader to the manufacturer for purchases.

(b) Agreements to pay by Instalments

In a contract for the sale of goods, the price of which is to be paid by instalments, the property in the goods passes to the buyer on delivery, and the seller becomes a creditor for the price. The transactions may be recorded as follows:

(1) BUYER'S BOOKS: When the agreement to purchase goods on the instalment principle is entered into, the buyer should pass an entry through his journal, crediting the vendor with the total amount to be paid, debiting the Asset Account

with the present cash value of the article and an Interest Suspense Account with the difference, representing the total interest.

As each instalment becomes due, an amount should be written off the Interest Suspense Account representing the proportion of the total interest included in the instalment, and debited to Profit and Loss Account. When the instalment is paid, cash is credited, and the Vendor's Account debited.

Alternatively, the interest may be dealt with as already explained in connection with hire-purchase, being credited to the vendor as it accrues, no Suspense Account being opened.

Depreciation should be provided for in the usual way, on the full cash value of the asset.

Illustration

X purchases on 1st January some goods which he arranges to pay for over a period of two years by half-yearly instalments of £120. The company supplying the goods charges interest at the rate of 6 per cent. per annum, and the present cash value of the goods is £446 1s. 0d. Show the Interest Suspense Account in the books of X.

INTEREST SUSPENSE ACCOUNT

			£ s. d.				£ s. d.
Jan.	1	To Sundries	33 19 0	June	30	By Profit and Loss Account 6% on £446 1 0	13 7 8
						" Balance c/d	20 11 4
			33 19 0				£33 19 0
July	1	To Balance b/d.	20 11 4	Dec.	31	By Profit and Loss Account—6% on £339 8 8	10 3 8
						" Balance c/d	10 7 8
			£20 11 4				£20 11 4
Jan.	1	To Balance b/d	10 7 8	June	30	By Profit and Loss Account—6% on £229 12 4	6 17 9
						" Balance c/d	3 9 11
			£10 7 8				£10 7 8
July	1	To Balance b/d	3 9 11	Dec.	31	By Profit and Loss Account—6% on £116 10 1	3 9 11
			£3 9 11				£3 9 11

	£ s. d.
The total amount of the instalments comes to	480 0 0
From which must be deducted the present cash value of the goods	446 1 0
Leaving the total charge for interest ...	£33 19 0

(2) SELLER'S BOOKS. The Buyer's Account is debited at the outset with the full amount payable under the contract, Sales Account being credited with the present cash value of the goods, and Interest Suspense Account with the total amount of interest. As each instalment becomes due, a proportionate amount of the interest

is transferred from Interest Suspense Account to the credit of Profit and Loss Account. On the payment of instalments, cash is debited, and the Buyer's Account credited. Alternatively, the Interest Suspense Account can be dispensed with, the Buyer's Account being debited with the cash value and interest as it accrues, in the manner first described in connection with hire-purchase.

By the above methods the seller takes credit through the Sales Account for profit equal to that which he would have made had he sold the article in question for cash, and as regards the interest, he takes credit for a proportionate amount as each instalment becomes due. The balance of the Buyer's Account at any time will show the balance still payable under the agreement, or, if the second method is adopted, the balance subject to interest.

It will be necessary to make ample provision in respect of possible bad debts on these transactions, and, unless the seller is in possesion of sufficient working capital, it may be inadvisable to take credit for the whole profit on the sale in the Profit and Loss Account of the year in which the sale was affected. Any proportion of the profit thus carried forward should be credited to a special Suspense Account.

§ 2. Mine, etc. Rents and Royalties

The rent of a mine or quarry is rarely fixed in amount, but is generally in the nature of a royalty based on the output. In such cases there is usually a clause in the lease fixing a minimum or dead rent, which must be paid, whatever the output may be. This minimum rent merges into a royalty rent, so that the actual rent paid is either the minimum rent or the royalty rent, whichever is the greater. Another clause frequently found in such leases is that dealing with short workings, which provides that where the royalty rent based on the output is less than the minimum rent, the difference may be recouped subsequently when the royalty rent exceeds the minimum rent. A fixed limit of time is usually prescribed within which to recoup these short workings, or, as they are sometimes called, redeemable dead rents. It should be remembered that the landlord will not in any period receive in cash an amount less than the minimum rent for that period. Income tax is deductible from royalties in the same way as from annual interest.

The entries in the books will be as follows:

(a) Where the minimum rent for any particular period exceeds the royalty rent

(1) Compute the amount of the royalty rent, debit Royalties Account and credit the Landlord's Account therewith. The Royalties Account will be written off to Profit and Loss Account.

(2) Debit Short Workings Account and credit the Landlord's Account with the amount by which the royalties fall short of the minimum rent.

(3) Debit the Landlord's Account and credit cash with the amount paid, and Income Tax Account with the tax deducted.

Some accountants prefer to pass the transactions through a 'Minimum Rent Account,' in years in which only the minimum rent is paid. In which event the entries are as follows:

(1) Debit Royalties Account and credit Minimum Rent Account with the amount of the royalties.

(2) Debit Minimum Rent Account and credit the Landlord's Account with the minimum rent.

(3) Debit Short Workings Account and credit Minimum Rent Account with the balance of the Minimum Rent Account.

(4) Debit Landlord's Account and credit cash with the cash paid and Income Tax Account with the tax deducted.

(b) Where the royalty rent exceeds the minimum rent

(1) Debit Royalties Account and credit Landlord's Account with the amount of the royalties. The royalties account will be written off to Profit and Loss Account.

(2) Debit the Landlord's Account and credit Short Workings Account with the short workings recoverable in the year (if any).

(3) Debit the Landlord's Account and credit cash with the amount paid, and Income Tax Account with the tax deducted.

Where it is impossible to recoup short workings within the specified period, the balance of Short Workings Account can no longer be treated as an asset in the Balance Sheet, but must be written off to Profit and Loss Account. In practice, the balance of the Short Workings Account, although treated as an asset in the Balance Sheet, is generally provided for to the full amount. If there is no reasonable expectation of its being recouped, it should be written off at once.

Illustration (1)

A company leased a mine at a minimum rent of £1,500 per annum, merging into a royalty of sixpence per ton. The short workings were recoverable during the first five years of the lease only. The output for the first six years was 36,000, 52,000, 58,000, 72,000, 76,000 and 96,000 tons of mineral, respectively. Show the accounts recording these transactions, ignoring income tax.

ROYALTIES ACCOUNT

1st Year	To Landlord's Account	£ 900	1st Year	By Profit and Loss Account	£ 900
2nd „	„ „ „	£ 1,300	2nd „	„ „ „ „	£ 1,300
3rd „	„ „ „	£ 1,450	3rd „	„ „ „ „	£ 1,450
4th „	„ „ „	£ 1,800	4th „	„ „ „ „	£ 1,800
5th „	„ „ „	£ 1,900	5th „	„ „ „ „	£ 1,900
6th „	„ „ „	£ 2,400	6th „	„ „ „ „	£ 2,400

LANDLORD'S ACCOUNT

		£			£
1st Year	To Cash and Income Tax	1,500	1st Year	By Royalties Account ..	900
				„ Short Workings Account	600
		£1,500			£1,500
		£			£
2nd „	„ „ „ „ „	1,500	2nd „	By Royalties Account	1,300
				„ Short Workings Account	200
		£1,500			£1,500
		£			£
3rd „	„ „ „ „ „	1,500	3rd „	By Royalties Account	1,450
				„ Short Workings Account	50
		£1,500			£1,500
		£			£
4th „	To Cash and Income Tax .	1,500	4th „	By Royalties Account	1,800
	„ Short Workings Account	300			
		£1,800			£1,800
		£			£
5th „	To Cash and Income Tax	1,500	5th „	„ „ „	1,900
	„ Short Workings Account	400			
		£1,900			£1,900
		£			£
6th „	To Cash and Income Tax	£2,400	6th „	„ „ „	£2,400

SHORT WORKINGS ACCOUNT

		£			£
1st Year	To Landlord's Acccount ...	600	4th Year	By Landlord's Account	300
2nd „	„ „ „ ...	200	5th „	„ „ „	400
3rd „	„ „ „ ..	50		„ Profit and Loss Account	150
		£850			£850

There are instances where mining rights held on lease are sub-let, in whole or in part, possibly at an enhanced royalty. In such a case, the first lessee remains liable to the head lessor for the agreed royalty on the full output, irrespective of the arrangements made between the lessee and the sub-lessee, and where the latter is entitled to recoup short workings, the lessee must take care to provide therefor, otherwise he may find himself paying royalties on the output of the sub-lessee in respect of which he has had the latter's royalties (in the shape of mimimum rent) in earlier years, *e.g.*, if A leased land for mining at a minimum rent of £200 merging in a royalty of 6d. per ton, and A sub-leased half the land to B at a minimum rent of £120 merging in a royalty of 8d. per ton, with the right to recoup short workings, and in the first year B produced 3,000 tons, A would receive the minimum rent of £120 (equivalent to 8d. per ton on 3,600 tons), but (subject to his own output plus the output of B exceeding A's minimum rent) would pay to his landlord in respect of B's output, 3,000 tons at 6d. = £75. A must then face the fact that, in due course, B may recoup the deficiency, but when he does so, A will still have to pay 6d. per ton on B's full output. Accordingly A should provide for such potential liability on 600 tons at 6d. = £15. There is no need for him to provide the full deficiency of 600 tons at 8d. = £20, since credit for the profit of 2d. per ton can be taken in the year in which it is received; nevertheless, it is probably better to carry it forward so long as it is available for recoupment, so as to have a complete record of the position as regards the sub-lessee.

Illustration (2)

A B Co., Ltd., work minerals under a lease from C D. The lease is for a period of 20 years from 1st January, 19..., and the rent payable is a minimum of £2,000 a year, merging in a royalty of 6d. a ton, payable half-yearly on 30th June and 31st December.

A B Co., Ltd., granted a sub-lease to R S Co., Ltd., of one-third of the area, for a period of 10 years from the following 1st July, for a minimum rent of £750 a year merging in a royalty of 9d. a ton, payable half-yearly on 30th June and 31st December.

A B Co., Ltd., are entitled under their lease from C D to recoup short workings out of subsequent excess workings throughout the term of the lease, but R S Co., Ltd., are only entitled, by their sub-lease, to recoup short workings out of excess workings in any of the four half-years immediately following that in which the short workings accrued.

Minerals were worked as follows:

	By A B Co., Ltd.	By R S Co., Ltd.
1st half-year	30,000 tons	
2nd „	32,000 „	4,000 tons
3rd „	40,000 „	8,000 „
4th „	36,000 „	10,000 „
5th „	30,000 „	15,000 „
6th „	35,000 „	12,000
7th	25,000 „	10,000 „

Show the Royalties Account and Short Workings Accounts, under the lease and the sub-lease, in the books of A B Co., Ltd., which are closed yearly on 30th June.

How should the balances, if any, on the above accounts be dealt with in the annual balance sheets and accounts of A B Co., Ltd.?

ROYALTIES ACCOUNT

		£			£
1st Year June 30	To Landlord	750	1st Year June 30	By Profit and Loss Account	750
2nd Year Dec. 31	To Landlord	900	2nd Year Dec. 31	By R. S. Co., Ltd.	150
June 30	„ Landlord	1,200	June 30	„ R. S. Co., Ltd.	300
				„ Profit and Loss Account	1,650
		£2,100			£2,100
3rd Year Dec. 31	To Landlord	1,150	3rd Year Dec. 31	By R.S. Co., Ltd.	375
June 30	„ Landlord	1,125	June 30	„ R. S. Co., Ltd.	563
				„ Profit and Loss Account	1,337
		£2,275			£2,275
4th Year Dec. 31	To Landlord	1,175	4th Year Dec. 31	By R. S. Co., Ltd.	450
June 30	„ Landlord	875	June 30	„ R. S. Co., Ltd.	375
				„ Profit and Loss Account	1,225
		£2,050			£2,050

T WORKINGS ACCOUNT, C D

		£			£
1st Year June 30	To Landlord	250	2nd Year June 30	By Landlord ...	200
2nd Year Dec. 31	„ do. ..	100	3rd Year Dec. 31	„ do. ...	150
		£350			£350
4th Year June 30	To Landlord	125			

SHORT WORKINGS ACCOUNT, R S CO, LTD.

		£			£
2nd Year June 30	To Balance c/d.	300	2nd Year Dec. 31	By R S Co, Ltd. ..	225
			June 30	„ R S Co., Ltd. ...	75
		£300			£300
3rd Year June 30	To R S Co., Ltd.	188	3rd Year July 1	By Balance b/d.	300
	„ Balance c/d.	112			
		£300			£300
4th Year Dec. 31	To R S Co., Ltd.	75	4th Year July 1	By Balance b/d.	112
June 30	„ Profit and Loss Account, Short Workings for half-year ended 30th June, no longer recoupable	37			
		£112			£112

Note. The whole amount of the short workings of R S Co. Ltd. has been carried forward each year, although it would be permissible to reduce the carry forward to 6d. per ton on the short workings, this being the amount of the liability of A B Co. Ltd., to its landlord in due course when the minerals are won. The above treatment is more conservative, however, and ensures a record of the short workings in A B Ltd.'s books, comparable with the records in the books of R S Co. Ltd

§ 3. Farmers' Accounts

The Ministry of Agriculture and Fisheries has issued a booklet explaining, in very simple language, how the farm books should be kept and how the profit or loss arising from the farming operations should be ascertained.

The farmer should make an inventory and valuation of his farm assets, such as livestock, growing crops, foodstuffs, manures, seeds, etc., at the beginning and end of each year, the basis of valuation being cost or market value, whichever is the lower. In the case of livestock, where the farmer is unable to estimate the actual cost of home-bred cattle, sheep or pigs, they may be brought in at 75 per cent. of the current market value of each animal at the time of the valuation. The cost figure of home grown grain, straw, hay, roots, etc., may be taken at market (or controlled) price, less 15 per cent.

A record must be kept of all receipts and payments which, for the purposes of the Profit and Loss Account must be analysed under appropriate heads, adjustment being made at the end of each accounting period for outstandings and accruals in the usual way. As a general rule, only two-thirds of the amount of the rent (or, in the case of an owner-occupier, of the net Schedule A value) of the farmhouse may be charged in the farm accounts, one-third being attributable to personal use. There must also be credited to the Profit and Loss Account and debited to the farmer's Current (or Drawings) Account the estimated value of the farm produce, etc., consumed by the farmer and his family. Depreciation of Machinery and Plant should be provided for, but in the case of small tools, in respect of which capital allowances are not given for income tax purposes, the cost of replacement should be charged.

The following illustration shows the form in which the farm Profit and Loss Account may be prepared.

Illustration

J. SMITH
THE MEADOW FARM
PROFIT AND LOSS ACCOUNT FOR YEAR ENDED 31ST DECEMBER

	£	£		£	£
To Valuation at 1st January :			By Sales :		
Dairy Herd and other Cattle	3,200		Corn, Vegetables, etc.	1,800	
Horses	120		Milk	3,900	
Hay and Straw	51		Cattle	950	
Corn, Roots and Stores	577		Fruit	200	
Cultivations and Manures applied	403				6,850
Manures on hand	100		" Own Consumption	75	
		4,451	" Subsidies and grants	62	
" Livestock Purchases :					137
Cattle	120		" Valuation at 31st December		
Horses	50		Dairy Herd and other Cattle	3,500	
		170	Horses	150	
" General Purchases :			Hay and Straw	180	
Fertilisers	642		Corn, Roots and Stores	300	
Seeds	390		Cultivations and Manures applied	1,200	
Feeding Stuffs	1,260		Manures on Hand	130	
		2,292			5,460
" Labour Charges :			" Net Loss for year		1,661
Wages and National Insurance	2,800				
Sub-contracted work	180				
		2,980			
" General Expenses :					
Motor and Tractor Running	800				
Repairs and Maintenance	960				
Tool Usage	105				
Rent, Lighting, Heating, etc.	1,250				
		3,115			
" Depreciation		1,100			
		£14,108			£14,108

§ 4 Fire Claims for Stock

Where stock-in-trade is destroyed by fire and the exact value thereof is unknown, the usual method of ascertaining the amount of the claim is to prepare an estimated Trading Account for the period since the last accounts were drawn up. The average rate of gross profit on turnover for past years will be ascertained, and the percentage so arrived at, calculated on the sales for the particular period under review, will be considered to represent the estimated gross profit for the period. The balance of the account will then show the estimated stock which was damaged and destroyed.

Where the books of account have been destroyed, it becomes more difficult to obtain the details necessary to prepare the estimated Trading Account. In order to arrive at the approximate amount of sales, all known customers should be circularised. From the replies and the knowledge of the proportion of cash sales, the approximate sales for the period can be estimated.

Similarly, all suppliers should be circularised, and an estimate of the total purchases thus obtained. Copies of previous Profit and Loss Accounts and Balance Sheets will usually be available in the hands of auditors or Inspectors of Taxes, so there should be no difficulty in arriving at the opening stock value or the usual percentage of gross profit.

In circularising the customers and suppliers, care should be taken to ask for the corresponding figures for the previous year, in order that estimates can be made by comparison. The bank statements will assist in building up estimates, particularly in respect of wages, where wages are charged in the Trading Account.

Any partially destroyed stock will be valued, and the amount deducted from the amount of the estimated total stock. The resulting figure will represent the claim to be made against the insurance company. If uninsured, the cost of the stock lost must be charged to Profit and Loss Account.

Illustration (1)

John Smith carries on business as a timber merchant. On 31st March, a fire occurred at his yard, and the greater portion of his stock was destroyed, the value of the portion salved being £600. His books, however, were saved, and from these it appeared that on 1st January, his stock amounted to £3,000. The purchases to 31st March, were £5,000, whilst the sales were £7,200. From an examination of his accounts for the previous three years it appears that the gross profit on the sales was 25 per cent. He is insured against fire.

Prepare a statement showing what amount he should claim from the insurance company.

JOHN SMITH

ESTIMATED TRADING ACCOUNT FOR THREE MONTHS ENDED 31ST MARCH

	£		£
To Stock at 1st January	3,000	By Sales	7,200
„ Purchases	5,000	„ Estimated Stock at 31st March	2,600
„ Estimated Gross Profit, being 25% on sales of £7,200	1,800		
	£9,800		£9,800

The above account shows the stock to be of the estimated value of £2,600 at the date of the fire. The value of the stock salved being agreed at £600, a claim will be made against the insurance company for £2,000.

Frequently the salvaged stock can be made saleable after it has been reconditioned. Its value should be credited to the Trading Account and debited to Salvaged Stock Account, any expenses incurred being charged to the latter account. As sales are effected they should be credited to the Salvaged Stock Account, the ultimate profit or loss on which should be transferred to Profit and Loss Account (*not* to Trading Account, since this is not an ordinary trading transaction). If any of the salvaged stock remains on hand at a Balance Sheet date, it must be valued (at cost or market value, whichever is lower) and carried down on the account.

Illustration (2)

Taking the facts in the previous illustration, assume that £200 was spent in re-conditioning the stock. Sales were effected to an amount of £900, and at the Balance Sheet date the stock was valued at £125. Write up the account.

SALVAGED STOCK ACCOUNT

	£		£
To Trading Account	600	By Sales	900
„ Expenses	200	„ Stock c/d	125
„ Profit and Loss Account—profit	225		
	£1,025		£1,025
To Stock b/d.	125		

§ 5. Claims under Loss of Profits (Consequential Loss) Insurance Policies

Insurance policies are frequently effected to provide compensation for loss of profits consequent upon the disorganisation of a business in consequence of a fire. It is usual for such a policy to cover the loss of net profit, together with standing charges and

any increased cost of working, such as the renting of temporary premises, until the turnover of the business reaches normal conditions.

The contemplated period of disorganisation for which the insurance is effected is known as the 'period of indemnity' and its length will vary with the nature of the business and the delay anticipated in obtaining new machinery, equipment, etc. The longer the period of indemnity for which cover is required the greater will be the amount of the premium charged.

The normal method of calculating a claim under such a policy is by way of a percentage on loss of turnover, such percentage being either a rate agreed by the terms of the policy or based on certified accounts of the year preceding the year in which the fire occurred. The loss of turnover is the difference between the turnover for the period of indemnity covered by the policy and the turnover for the corresponding period in the preceding year. The agreed percentage on this difference represents the loss suffered, to which may be added any specified increased costs of working, covered by the policy, to arrive at the total claim.

Illustration (1)

The principles underlying the claim can readily be seen from the following comparative accounts.

TRADING AND PROFIT AND LOSS ACCOUNTS

	Year 1955	Year 1956		Year 1955	Year 1956
	£	£		£	£
To Stock	3,000	2,000	By Sales	40,000	28,000
,, Purchases	29,000	21,500	,, Stock	2,000	2,500
,, Gross Profit	10,000	7,000			
	£42,000	£30,500		£42,000	£30,500
Expenses fluctuating with turnover	2,000	1,400	By Gross Profit	10,000	7,000
Standing Charges	6,100	6,500	,, Net Loss		900
Net Profit	1,900				
	£10,000	£7,900		£10,000	£7,900

The result of the fall in turnover plus the increase in standing charges has been to convert a profit of £1,900 into a loss of £900, the business thus being worse off to the extent of £2,800. In order to meet the normal standing charges and to make the normal profit, a percentage on turnover must be earned equal to the total of those two items. Assuming 1955 to be the basic year, the percentage on turnover must be $\frac{£6,100 + £1,900}{40,000} \times \frac{100}{1} = 20\%$.

(The amount to be earned is thus equal to gross profit less charges which fluctuate with turnover, viz., £10,000-£2,000 = £8,000. Where there is no turnover, there will be no variable expenses, but many standing charges will continue whilst the business is carried on.)

The effect of the fall in turnover is thus:

Loss of 20% on fall in turnover, 20% on (£40,000-£28,000)	£2,400
Increase in Standing Charges	400
Total	£2,800

What is true of a whole year is true of part of a year, provided the same period in each year is taken to ascertain the fall in turnover.

Illustration (2)

Date of Fire, 1st June.

Amount Insured, £12,000.

Percentage of net profit and standing charges to turnover, 12 per cent.

	Turnover prior to fire.	Turnover after fire.	Decrease
	£	£	£
June ...	12,000	Nil.	12,000
July ...	13,000	500	12,500
August ...	11,500	1,500	10,000
September	12,500	5,000	7,500
October ...	13,000	8,000	5,000
November	12,700	10,000	2,700
	Total decrease ..		£49,700
	Claim 12% on Total Decrease .		£5,964

When formulating a claim for loss of profits the following factors must *inter alia* be borne in mind:

(a) The turnover of the corresponding period of the previous year is not necessarily a true indication of the turnover which would have been obtained during the current year had the fire not taken place. It may be shown that there has been a definite upward or downward trend in sales which would have continued during the period, which has now suffered by reason of the fire, in which case, appropriate adjustments are essential to compare actual turnover with that which could properly have been expected.

(*b*) The percentage of net profit plus standing charges based on turnover as shown by past accounts may not reflect the present earning capacity of the business. A change in the cost of materials, selling prices, manufacturing operations, nature of the product sold, etc., will each cause a variation in the percentage of profit earned.

In order to follow the formula laid down in the modern standard policy, it is necessary to have regard to the following definitions used in the contract:

(i) *Gross Profit:* The sum produced by adding to the net profit the amount of the insured standing charges, or if there be no net profit, the amount of the insured standing charges less such a proportion of any net trading loss as the amount of the insured standing charges bears to all the standing charges of the business.

The insured standing charges are those charges specified in the policy which the insured desires to recover in the event of damage.

(ii) *Turnover:* The money paid or payable to the insured for goods sold and delivered and for services rendered in the course of the business at the premises.

Net profit and standing charges bear a direct relationship to the turnover of a business. Consequently, turnover as a basis for measuring the loss sustained provides a reliable guide.

(iii) *Indemnity Period:* The period beginning with the occurrence of the damage and ending not later than......months thereafter during which the results of the business shall be affected in consequence of the damage.

The period chosen sets the limit on the time during which compensation is payable under the policy.

(iv) *Rate of Gross Profit:* The rate of gross profit earned on the turnover during the financial year immediately before the date of the damage.

(v) *Annual Turnover:* The turnover during the twelve months immediately before the date of the damage.

(vi) *Standard Turnover:* The turnover during that period in the twelve months immediately before the date of the damage which corresponds with the indemnity period.

(vii) *Average:* The 'average clause' reads: 'provided that if the sum insured by the policy be less than the sum produced by applying the rate of gross profit to the annual turnover the amount payable shall be proportionately reduced'.

This is a simple condition of average. If the company insures for only a proportion of its gross profit, then it can only expect to recover a corresponding proportion of the loss.

Illustration (3)

The premises of Conflagration Ltd. were partially destroyed by fire, and as a result the business was disorganised from 1st March to 31st August. The company is insured under the terms of a tariff 'standard' Loss of Profits Policy for £11,000. The period of indemnity specified in the policy was six months.

The accountants to Conflagration Ltd. certified the following information extracted from the books of the insured:

	£
1. Actual Turnover during the period of dislocation (March/August) ..	7,000
2. Turnover for the corresponding period in the twelve months immediately before the fire (i.e. the standard turnover)	20,000
3. Turnover for the twelve months immediately preceding the fire (i.e. the 'annual turnover)	50,000
4. Net profit, plus standing charges of last *financial year*	12,000
5. Turnover for the last *financial year*	48,000

Due to a substantial increase in trade before and up to the time of the fire, it was agreed that an adjustment of 10 per cent. should be made in respect of the disclosed upward trend in turnover (as stipulated in the adjustments clause in the policy), so as to bring the pre-fire figures up to the level that could reasonably have been expected during the indemnity period if the fire had not occurred.

The company incurred additional expenses amounting to £500 immediately after the fire which avoided or reduced the shortage in turnover that would otherwise have occurred. It was also ascertained that a saving of £250 was made in *insured standing charges* in consequence of the fire during the indemnity period.

Compute the claim by Conflagration Ltd. under the policy.

PARTICULARS OF CLAIM

	£
Shortage of Turnover	
Turnover for six months (March/August) in previous year (standard turnover)	20,000
Add expected increase of 10 per cent. (as agreed)	2,000
	22,000
Less actual turnover during the period of indemnity	7,000
Shortage in turnover due to fire	£15,000
Annual Turnover	
Turnover for the twelve months immediately preceding the fire	50,000
Add increase of 10 per cent., as agreed	5,000
	£55,000

Rate of Gross Profit

$$\frac{\text{Net profit, plus insured Standing Charges for last financial year}}{\text{Turnover for last financial year}} = \frac{12,000}{48,000} = 25\%$$

FORMULA FOR STATEMENT OF CLAIM

1. Clause (*a*) Loss through reduction in turnover, 25 per cent. of £15,000 ...	£3,750
(*b*) Loss incurred through increase in cost of working	500
	4,250
2. *Less* saving in insured Standing Charges	250
	£4,000

3. *Average.*—Since the sum insured, viz., £11,000, is less than the adjusted 'gross profit' for the year, ascertained as above, viz., 25 per cent. on £55,000 ... ... = £13,750

the insured must bear a proportionate part of the loss sustained, and the amount payable under the policy is therefore, reduced to

$$\frac{\text{Sum Assured, £11,000}}{\text{Adjusted Gross Profit, £13,750}} \times \text{£4,000} \qquad \text{£3,201}$$

Notes

(1) If the company had omitted to cover one or more of its standing charges e.g., if the total of all standing charges had been £13,000, but an item of £1,000 was not included in the cover, the proportion payable in relation to the extra cost of working shown in clause (*b*) in the above claim would be reduced to : $\frac{\text{Net profit, plus insured standing charges, £12,000}}{\text{Net profit, plus } all \text{ standing charges, £13,000}} \times$ £500 = £461, and this amount would have been taken into consideration in arriving at the loss.

(2) It will be noticed that the *whole* of the saving in insured standing charges must go to reduce the ascertained loss in accordance with the terms of the policy.

§ 6. Claims for Compensation

Professional accountants are often required to prepare accounts substantiating claims for compensation, either for personal injuries sustained, or for damages in respect of the destruction or disturbance of a business, e.g. as a result of the compulsory acquisition of premises by a local authority or Government department.

In the case of a claim for damages in respect of personal injuries sustained, the chief points to be considered are:

(1) The claimant's actual income from his business.

(2) The extent of the injuries sustained. If the accident results in total disablement of the claimant and inability to attend to his business, he will be entitled to a much larger sum by way of damages than if the disablement were only partial.

(3) Whether the claimant can easily realise the full amount of the capital in his business, or whether a loss will be made.

Where the claim for compensation is on account of destruction or disturbance of business, the chief points to take into account are:

(1) The loss on trading which it is anticipated will be sustained.

(2) If it is a question of compulsory sale of a lease, the unexpired period and terms of the lease, and the possibilities of obtaining alternative (and may be better) accommodation

(3) The probable loss on sale of fixtures and fittings.

(4) The loss in respect of compulsory sale of stock (if any).

(5) Loss of beneficial interest through compulsory removal, and the effect on goodwill.

Illustration

A B, an ironmonger, carried on business for upwards of 15 years in premises situate in High Street, held under a lease, of which 9 years are unexpired, and at an annual rent of £250. The property being required for street improvements, and A B, having received due notice from the proper authority, he claims compensation for disturbance. If A B's Solicitor were to instruct you to prepare a Statement of Claim, what accounts would you prepare?

State the grounds upon which the claims would be based, and, by means of assumed figures, make out a statement showing the items of which it would be composed.

Trading and Profit and Loss Accounts for three to five years, according to the circumstances of the case, would be produced in support of the claim. The compensation claimed would be in respect of the following losses:

(1) Loss of beneficial interest through compulsory removal, which may or may not amount to the entire goodwill, according to the circumstances of the case.

(2) The present value of the lease, plus a percentage for compulsory removal.

(3) Loss on fixtures according to the facts of the case.

(4) Loss in respect of compulsory sale of stock (if any).

The Statement of Claim might take the following form:

STATEMENT OF CLAIM

FOR COMPENSATION IN RESPECT OF COMPULSORY REMOVAL

	£
Loss in respect of Beneficial Interest, 6 years' average super-profits as per accounts enclosed	6,000
Present Value of Lease, plus 10% for compulsory removal	550
Loss on Fixtures	750
Loss in respect of compulsory sale of Stock	1,000
Total Claim	£8,300

§ 7. Bankers' Accounts

The principal functions of a joint stock bank are:

(1) To receive deposits from customers and collect cheques, bills of exchange and other credit instruments on their behalf; and to pay on demand cheques drawn on

current accounts, and repay deposit accounts, after the required period of notice has expired.

(2) To discount bills of exchange and promissory notes on behalf of customers and others.

(3) To grant loans and overdrafts. Some banks prefer to advance a fixed sum on loan account, crediting the amount thereof to the customer's current account so that he can draw against it. In other cases the required accommodation is given by way of overdraft, *i.e.*, the customer is allowed to draw cheques up to a specified limit in excess of the amount standing to the credit of his current account. Interest is charged on the amount of the fixed loan, or on the amount of the overdraft for the time being, as the case may be.

(4) Agency services, such as the collection of foreign cheques, bills of exchange, dividend warrants and other credit instruments; the payment of 'standing orders' for subscriptions, insurance premiums and other regularly recurring liabilities on behalf of customers; the purchase and sale, through the bank's brokers, of stock exchange securities for customers; the services of the new issue department in connection with raising of fresh capital by a limited company (mainly the receipt of the application monies and financial business up to the allotment of the securities); the specialised services of the executor and trustee department; etc.

(5) Miscellaneous services, including the transaction of foreign exchange business, issuing traveller's cheques, letters of credit, etc.; the receipt for safe custody of plate, jewellery, title deeds to property, stock and share certificates and other valuables on behalf of customers.

Apart from balances with the Bank of England and other British banks, and cheques in the course of collection, the banks' resources are used for the purpose of earning income, in such a way, however, that a sufficient proportion of the assets is in a form in which they can be easily and speedily realised.

The total amount which banks will lend at any time is determined by the ratio of their cash Reserves (*i.e.*, cash and notes in the till plus balances at the Bank of England) to their liabilities. The experience of bankers teaches them that of the total amounts deposited by customers, only a small proportion is likely to be demanded at any given time, and every net increase in deposits will thus enable the banks to grant loans or overdrafts of a considerably larger amount. If, for example, it is the policy of the banks to maintain cash reserves equal to 8 per cent. of their liabilities, every increase of £100 in their *net* deposits (*i.e.*, deposits less withdrawals) will enable them to grant credits to the extent of a further £1,150, which, with the liability to customers for the £100 increased net deposits, will make up the ratio of $12\frac{1}{2} : 1$ of liabilities to cash reserves.

The typical bank Balance Sheet shows clearly how the bank's funds are employed, the various assets being set out in order of liquidity.

A banking company which is incorporated under one of the Companies Acts must comply with the requirements of Part III of the Eighth Schedule to the Companies

Acts, 1948, as respects the information to be disclosed in the accounts laid before its members. These requirements are indicated in Chapter VIII (§ 15 (*c*) and (*e*)).

A copy of the latest available published accounts of one of the 'big five' of the joint stock banks will be found in the Appendix.

Illustration

X BANK LTD.

BALANCE SHEET AS AT 31ST DECEMBER, 19 .

			£	£
Share Capital Authorised: 2,000,000 Shares of £10 each	20,000,000	Coin, Bank Notes and Balances with the Bank of England		26,500,000
Share Capital Issued: 2,000,000 Shares of £10 each, £2 10s paid	5,000,000	Balance with, and cheques in course of collection on, other Banks, and Cheques, Drafts, etc., in transit		17,500,000
Reserve Fund ...	2,000,000	Money at Call and Short Notice		27,000,000
Balance of Profit and Loss Account	500,000	Bills Discounted:		
	7,500,000	British Government Treasury Bills	64,000,000	
Dividend payable, *less* Income Tax ...	200,000	Bills payable by British Firms and Institutions in the United Kingdom	1,500,000	
Current, Deposit and other Accounts, including Contingency Reserves and provision for Taxation	345,000,000	Other Bills	200,000	
Acceptances and Confirmed Credits on account of Customers	11,000,000			65,700,000
Engagements on account of Customers	3,000,000	Investments:		
		British Government Securities	100,000,000	
		Other Quoted Securities, including Securities of Dominion and Colonial Governments, British Public Boards and British Municipal Corporations	800,000	
				100,800,000
		Advances to Customers and other Accounts		110,200,000
		Shares in Subsidiary Banks and and Companies		2,000,000
		Bank Premises, at cost, less amounts written off		3,000,000
		Liabilit		
		Acceptances, Endorsements, Engagements, etc., as per contr		14,000,000
	£366,700,000			£366,700,000

The following notes are given with regard to those items in the above Balance Sheet which are not self-explanatory

1. *Current, Deposit and other Accounts.* This item represents the total amounts standing to the credit of customers on Current and Deposit Accounts.

2. *Acceptances, Confirmed Credits and Engagements on account of Customers.* These items represent the liability which the bank has undertaken by the acceptance and endorsement of bills of exchange, by guarantees given to third parties, credits issued, and other obligations undertaken on behalf of customers. They are balanced on the other side of the Balance Sheet by assets representing the liabilities of the customers to the bank in respect of the obligations so undertakes.

3. *Coin, Bank Notes and balances with the Bank of England.* This item includes bank notes and coin in the tills and vaults of the Head Office and the branches of the bank, and the balance standing to the credit of the bank at the Bank of England.

4. *Money at Call and Short Notice.* This item represents advances repayable at call or at short notice, made to stock jobbers, bill brokers, and others, on the security of bills of exchange and investments.

5. *Treasury Bills.* These are instruments issued by the Treasury for periods of three or six months by tender. Bills are for a minimum denomination of £5,000

and tenders are not accepted for less than £50,000. They carry no interest but are issued at a discount.

6. *Advances to Customers and other Accounts.* This item includes all loans and overdrafts granted to customers, and normally forms the largest asset of the bank.

7. *Liabilities of Customers for Acceptances, Endorsements, etc.* This item represents the liability of customers to the bank in respect of the obligations undertaken on their behalf and appearing on the opposite side of the Balance Sheet.

§ 8. Voyage Accounts

The owner or charterer of a ship, in addition to ascertaining the profit or loss from carrying on his business for a period, should be in a position to determine the exact result of each voyage made. In order to do this, it is usual to open a separate account for each voyage, the accounts referring to each voyage being numbered consecutively.

The account should be charged with all expenses actually incurred in respect of the particular voyage, and with a proper proportion of all other charges which are attributable to the voyages generally, such as premiums on time policies, manager's remuneration, etc., and should be credited with the freight and other income earned. The final balance of the account will represent the profit or loss on the voyage.

The Voyage Account will be in the form of an ordinary Profit and Loss Account.

Illustration

The 'Glenisla' Steamship Company, Limited, own one 'tramp steamer', the s.s. 'Glenisla' which was chartered on 27th February, as follows:

(a) Cardiff to Genoa with general cargo at £3 per ton. The charter stipulates for an address commission to the charterers of 2 per cent. on the freight, payable on signing bill of lading, together with a brokerage of 5 per cent. to the charterers' agents, of which one-third is repayable to the vessel.

(b) Agua Amarga to Barrow with Ore at £1 10s. 0d. per ton. Address commission of 2 per cent. on freight payable to charterers and a brokerage of one-third of 5 per cent. payable to charterers' agents on signing charter.

The vessel was insured at Lloyd's on 29th April, the inclusive premium for one year being £3,000, and the managing owners' remuneration was fixed by the articles of association at 5 per cent. of gross freight charges.

The following are the particulars from which the accounts are to be made up:

	£
Freight on 3,000 tons general cargo to Genoa, and on 3,500 tons Ore to Barrow	14,250
Stores Account	560
Port Charges, etc., Cardiff	350
Captain's Accounts for Harbour Wages, etc., Cardiff	150
Bunker Coals	1,600
Discharging at Genoa	145
Agents' Disbursements, Genoa	75
Captain's Expenses, Genoa	15
Stevedores at Agua Amarga	420
Provisions	640
Repairs on voyage	125
Captain's Expenses, Amarga	10
Agents' Accounts for Port Charges, Agency, etc., exclusive of Address Commission and Brokerage	150
Wages	1,750
Port Charges and Discharging at Barrow	1,150
Captain's Portage Bill	325
Proportion of annual provision for repairs and replacement	2,500

The voyage terminated on 28th April.

Prepare the Voyage Account, apportioning where necessary in months.

VOYAGE ACCOUNT, 27TH FEBRUARY TO 28TH APRIL

		£		£
To Stores Account		560	By Freight.	
Port Charges, etc.		350	Outward—3,000 tons of general cargo from Cardiff to Genoa at £3 per ton (a)	9,000
Captain's Account, Cardiff		150	Homeward—3,500 tons of Ore to Barrow at £1 10s. per ton (b)	5,250
Bunker Coals		1,600	" Brokerage refunded on (a): One-third of £450	150
Wages		1,750		
Discharging at Genoa		145		
Agents' Disbursements, Genoa		75		
Captain's Expenses, Genoa		15		
Stevedores at Agua Amarga		420		
Provisions		640		
Repairs		125		
Captain's Expenses		10		
Port Charges, Agency, etc.		150		
Port Charges, etc., at Barrow		1,150		
Captain's Portage Bill		325		
Address Commissions:				
2% on £9,000	180			
2% on £5,250	105			
		285		
Brokerage:				
(a) 5% on £9,000	450			
(b) One-third of 5% on £5,250	87			
		537		
Insurance Premium for 2 months		500		
Managing Owners' Commission		712		
Provision for Repairs and Replacement		2,500		
Profit on Voyage		2,401		
		£14,400		£14,400

§ 9. Marine Insurance Accounts

There are three parties to be considered in dealing with these accounts:

(1) The person for whom the insurance is effected.

(2) The marine insurance broker.

(3) The underwriter.

When a person wishes to insure a ship or cargo, he will communicate his wishes to an insurance broker, who will discuss with the underwriters with whom he desires to place the insurance the premium they require.

This premium, in the case of cargo insurance, is subject to brokerages of 5 per cent., 10 per cent., and 2½ per cent., each percentage being calculated on the premium less the preceding percentage. Thus, if the premium were £100 the brokerage would be 5 per cent. of £100 + 10 per cent. of £95 + 2½ per cent. of £85 10s. 0d. = £16 12s. 9d. The total brokerage is deducted by the broker from the payment which he makes to the underwriter and the broker allows a discount of 9½ per cent. to the person for whom the insurance has been effected. In the case of insurance of the ship itself, i.e., on the 'hull', the brokerages are 5 per cent. and 10 per cent.

When a claim is made under a policy, it is the business of the insurance broker to collect the amount of the loss on behalf of his client, from the various underwriters *pro rata*, receiving for his services a commission calculated at an agreed percentage on the total amount of the claim. Thus the broker will collect the full amount of the loss from the underwriters, and pay this to his client, less the agreed collecting commission.

Owing to the nature of the contract of underwriting, it is necessary for each year's account to be kept open for three years. There are, therefore, always three accounts

open, except at the date of the Balance Sheet, when the first of the three accounts then open will be closed.

Illustration

The following are the balances on 31st December, 1958, in the books of A. Wreck, an underwriter at Lloyds:

		1956 Account £	1957 Account £	1958 Account £
Premiums (*less* Returns and Reinsurances) ...	1st year	201,800	202,000	262,100
	2nd ,,	72,300	68,400	—
	3rd ,,	6,145	—	—
Salvages	1st ,,	8,560	9,010	2,130
	2nd ,,	7,860	8,170	—
	3rd ,,	925	—	—
Taxed Dividends and Interest received during	1953	1,115	—	—
	1954	1,250	1,310	—
	1955	1,440	1,545	1,215
Claims	1st year	38,370	68,500	64,750
	2nd ,,	169,600	191,000	—
	3rd ,,	32,140	—	—
Expenses (including Commission)		15,300	19,150	18,140
Reinsurances to close 1956 Account		10,200	—	—
Investments (all accounts) at cost			52,825	
Creditors			10,300	
Debtors			42,400	
Balance at Bank			215,200	
Capital Account: Balance on 1st January, 1958			70,000	

Prepare Underwriting Accounts to 31st December, 1955, and Balance Sheet as on that date.

A. WRECK

UNDERWRITING ACCOUNT FOR THE YEAR 1956

		£			£
1956 Dec. 31	To Claims ..	38,370	1956 Dec. 31	By Premiums (net) ..	201,800
	,, Expenses ..	15,300		,, Salvages ..	8,560
	,, Balance carried down ..	157,805		,, Taxed Dividends and Interest	1,115
		£211,475			£211,475
1957 Dec. 31	To Claims	169,600	1957 Jan. 1	By Balance brought down	157,805
	,, Balance carried down	69,615	Dec. 31	,, Premiums (net)	72,300
				,, Salvages	7,860
				,, Taxed Dividends and Interest ..	1,250
		£239,215			£239,215
1958 Dec. 31	To Claims	32 140	1958 Jan. 1	By Balance brought down ..	69,615
	,, Reinsurances	10,200	Dec. 31	,, Premiums (net)	6,145
	,, Profit and Loss Account	35,785		,, Salvages	925
				,, Taxed Dividends and Interest ...	1,440
		£78,125			£78,125

UNDERWRITING ACCOUNT FOR THE YEAR 1957

		£			£
1957 Dec. 31	To Claims	68,500	1957 Dec. 31	By Premiums (net)	202,000
	„ Expenses	19,150		„ Salvages	9,010
	„ Balance carried down	124,670		„ Taxed Dividends and Interest	1,310
		£212,320			£212,320
1958 Dec. 31	To Claims	191,000	1958 Jan. 1	By Balance brought down	124,670
	„ Balance carried down	11,785	Dec. 31	„ Premiums (net)	68,400
				„ Salvages	8,170
				„ Taxed Dividends and Interest	1,545
		£202,785			£202,785
			1959 Jan. 1	By Balance brought down	11,785

UNDERWRITING ACCOUNT FOR THE YEAR 1958

		£			£
1958 Dec. 31	To Claims	64,750	1958 Dec. 31	By Premiums (net)	262,100
	„ Expenses	18,140		„ Salvages	2,130
	„ Balance carried down	182,555		„ Taxed Dividends and Interest	1,215
		£265,445			£265,445
			1959 Jan. 1	By Balance brought down	182,555

BALANCE SHEET AS AT 31ST DECEMBER, 1958

				£
Capital Account:			Balance at Bank	215,200
Balance at 1st January, 1958		70,000	Investments at cost	52,825
Profit from 1956 account		35,785	Debtors	42,400
		105,785		
Underwriting Accounts:	£			
1957	11,785			
1958	182,555			
		194,340		
Creditors		10,300		
		£310,425		£310,425

§ 10. Ledger Accounts for Investments

Where investments are numerous, the interest and dividends arising therefrom should be passed through the Investment Accounts in the ledger, so that it can be seen at a glance whether or not all the income due on each investment has been received. The best way of carrying this into effect is to have the Investment Accounts ruled with two columns on either side, one column for income and the other for capital. In most cases it is also convenient to have a third column for the nominal value or number of shares or units. In the case of fixed interest bearing stocks or shares the dates when dividends or interest fall due should be noted at the head of the account.

When income is received, cash is debited and the income column of the Investment Account credited, and, at the end of the period, the total income received from each investment is transferred to an Income from Investments Account. In cases where the income at the end of the period, although accrued due, has not actually been received, but can be computed, the amount of such accrual may be carried down

on the income column of the Investment Account. This should not, however, be done in trust accounts, in which credit should only be taken for income actually received.

Illustration (1)

An investment company held during the whole of the year, £1,000 4 per cent. debentures costing £987, in the Phoenix Iron Company, the interest being payable on the 30th June and 31st December in each year.

Show in the books of the company the Phoenix Iron Company Investment Account. Ignore income tax.

THE PHOENIX IRON COMPANY FOUR PER CENT. DEBENTURE ACCOUNT
INTEREST PAYABLE 30TH JUNE AND 31ST DECEMBER

Date.	Particulars.	Fo.	Nominal Value.			Date.	Particulars.	Fo.	Nominal Value.		
			£	£							£
Jan. 1	To Balance b/f. ...		1,000		987	June 30	By Cash ½ year's interest			20	
Dec. 31	,, Interest on Investments Account .			40		Dec. 31	,,			20	
							,, Balance c/d.		1,000		987
			£1,000	£40	£987				£1,000	£40	£987
Jan. 1	To Balance b/d.		1,000		987						

It is usual in Investment Accounts, to carry down the balances at cost, and not adjust them to the current market value of the investments. In the case of companies holding a large number of investments, the practice is for a schedule to be prepared, showing the book value and the market value of each investment at the date of the Balance Sheet, a general provision being made for depreciation, if the total market value is less than the total book value. If the market value exceeds the book value, no credit should be taken for the excess, as this is not a realised profit. Under the Companies Act, 1948, a note of the market value of quoted investments must be made on the Balance Sheet of a company in which investments appear as an asset.

The profit or loss resulting on the sale of investments should be adjusted when the sale takes place. Where only a portion of the investment is sold, the balance remaining should be brought down at the price at which it stood in the books, and the difference on the account will then represent profit or loss on the portion of the investment sold, which should be transferred to a Profit and Loss on Investments Account.

Where investments are sold *cum div.* (which implies that the whole of the next dividend will go to the purchaser), some portion of the amount received will represent the dividend (less tax) accrued to the date of sale on the stock sold, and, strictly speaking, the amount received should be apportioned accordingly, the amount representing accrued income to date being credited to the income column, and the balance to the capital column of the Investment Account.

In the same manner, when stocks are purchased *cum div.*, the portion of the purchase price representing the accrued dividend (less) tax may be debited to the income column of the Investment Account, the balance being debited to the capital column. As the stock is purchased *cum. div.*, the whole of the next dividend will be received, and should be credited in the income column, against which there will be a set-off on the debit side of the amount accrued to the date of purchase.

Most British Government and Municipal Corporation stocks are quoted *ex div.* about one month before the interest thereon is payable. Industrial securities are quoted *ex div.* at the commencement of dealings for the Stock Exchange account preceding the first day on which the company closes its transfer books. It will frequently be found that shares of large companies are quoted *ex div.* many weeks before the dividend is due, as it is necessary for such companies to close their transfer books long before dividends are payable owing to the volume of work involved in preparing and issuing the dividend warrents.

In arriving at the *ex div.* price, the full dividend (less tax) is deducted from the *cum div.* price. Accordingly, the price paid for the stock is short by the amount of the dividend accruing from the date of the transaction to the dividend date.

When stocks are bought *ex div.* therefore, it is permissible to debit the capital column and credit the income column of the Investment Account with interest from the date of purchase to the next dividend date; and when stocks are sold *ex div.*, correspondingly to debit income and credit capital. In the latter case the adjustment is sometimes effected by apportioning the dividend, when received.

In the case of stocks and shares which do not carry a fixed rate of interest, the adjustments between capital and income cannot be made on purchase or sale, since the amount of the dividend receivable is not then known. Any adjustment in such cases is therefore made when the next dividend is received.

Although in theory these adjustments should always be made, they are usually ignored in practice when the purchase and sale of investments is only incidental to the main purpose of the business carried on.

In the case of British Government securities having five years or less to run to maturity, dealings are subject to the accrued or accruing interest being accounted for between buyer and seller, up to the day for which the bargain is done. In these cases, therefore, the accrued or accruing dividend is known exactly from the contract.

Illustration (2)

On 1st March a trust company purchased £10,000 3 per cent. Government Stock (Interest payable 1st April, 1st July, 1st October and 1st January) at 87½ *cum div.* On 1st August, £2,000 stock is sold at 87 *cum div.*, and on 1st September, £2,000 stock is sold at 88¼ *ex div.* On 31st December, the date of the Balance Sheet, the market price was 88.

Show the ledger account of the investment for the year, ignoring income tax, brokerage and stamps, and making apportionments in months.

GOVERNMENT 3 PER CENT.

Date		Nominal Value	Income	Capital	Date		Nominal Value	Income	Capital
		£	£	£			£	£	£
Mar. 1	To Cash – Purchase at 87½ *cum div.* (2 months accrued income £50	10,000	50	8,700	Apr. 1	By Cash – 3 months Interest,		75	
	„ Transfer to Profit on Sale of Investments Account			25	July 1	„ Cash – 3 months Interest,		75	
	„ Transfer to Income on Investments Account		205		Aug. 1	„ Cash – Sale at 87 *cum div.* (accrued Income 1 month £5) . .	2,000	5	1,735
					Sep. 1	„ Cash – Sale at 88½ *ex div.* .	2,000		1,765
					Oct. 1	„ Cash – Interest on £8,000, £60 (1 month on £2,000 sold *ex div* £5 to capital) . .		55	5
					Dec. 31	„ Balance c/d .	6,000		5,220
						„ Balance 3 months accrued interest on £6,000 c/d ...		45	
	£	10,000	255	8,725		£	10,000	255	8,725
Jan. 1	To Balances b/d ...	6,000	45	5,220					

Notes.

(1) The above method of adjusting the accrued dividend when posting the capital items can only be utilised when the rate of dividend or interest is fixed; otherwise the adjustment will be made when the dividend is received.

(2) Where stock is purchased or sold, the *cum div.* price may be apportioned so as to give to income the amount of interest which is included in the price.

(3) Where stock is sold *ex div.*, interest thereon from the date of the sale to the due date of the dividend may be credited to capital, as the full interest, and not merely the amount accrued to date, was deducted from the *cum div.* to arrive at the *ex div.* price, which is therefore *less* than the true capital proceeds by the amount of interest accruing after the sale. In this case, the dividend received on 1st October in respect of the £2,000 stock sold on 1st September has been so apportioned.

(4) The balance of stock remaining in hand is brought down at the net cost, *viz* $\frac{6,000}{10,000} \times$ £8,700 as shown by the capital column (and not at the *cum div.* price at which it was purchased)

Where further amounts of the same stock are purchased, and sales take place during the same or subsequent periods, it is convenient to value the balance at the average cost of all the purchases during the period, plus those in hand at the beginning of the period. No objection can be taken, however, to using the 'first in first out' principle, and regarding the balance as being made up of the latest purchases, or even identifying the sales with the purchases more closely by seeing which specific items have, in fact, been parted with.

(5) The above practice is not the method adopted in connection with trusts, where the rights of parties are defined by specific legal rules, as to which, *see* Ranking, Spicer & Pegler's 'Executorship Law and Accounts'.

(6) Credit has been taken in the account for the interest, accrued to the balancing date, which amount is carried down and will appear in the Balance Sheet as an asset.

Many companies, having financed their expansion out of profits ploughed back into the business, find that their accumulated reserves represent a very large percentage of their issued share capital; in some cases they may actually exceed their capital. As a result, dividends declared on the issued share capital appear to be at a high percentage rate, whereas in fact the dividend should be compared with the real capital employed in the company, namely, the aggregate of the issued share capital and the accumulated profits. In order to bring the share capital into line with the real

capital employed, such companies frequently make bonus issues of shares to their shareholders. It will be appreciated that the assets underlying the share capital are not in any way changed by such a bonus issue and, therefore, in theory, the increased number of shares subsequently held by a shareholder are in total of the same value as his original holding. In practice, however, it is usually found that the market value of the total holding will have increased because it is hoped that the company will continue to pay the same rate of dividend on its increased capital as it did on its original capital or that it will at least pay a dividend which represents an increase on the former rate. Another reason why the total market value of the new capital will usually be found to exceed the original value is that the number of shares available for dealing on the Stock Exchange having increased, a rather more active market is created. From the viewpoint of the recipient of such bonus shares, however, they have been acquired without cost and therefore no value should be placed upon them in the books, the only amendment required in the holder's Investment Account being an addition to the number of shares held. If, however, the shareholder sells the bonus shares he receives, it would be permissible to take credit for the profit on such a sale, as the price obtained contains some element of the profit which existed on the original holding before the allotment of the bonus shares.

Illustration (3)

J. Brown purchased 1,000 ordinary shares of £1 each in Wyezed Company Limited for £1,250, inclusive of brokerage and stamp duty. Some years later the company resolved to capitalise profits and to issue to the holders of ordinary shares one new ordinary share for every share held by them. Prior to the capitalisation, the shares of Wyezed Company Limited stood in the market at 35s. per share. After the capitalisation the company's shares were dealt in on the market at 18s. 6d. per share. J. Brown decided to sell the bonus shares he received and the sale was effected at 18s. per share net. Write up the Investment Account in respect of the aforementioned transactions.

WYEZED CO. LTD. £1 ORDINARY SHARES

Date		Nominal	£	Date		Nominal	£
	To Cash	1,000	1,250		By Cash-Sale	1,000	900
	,, Bonus	1,000	—		,, Balance c/d	1,000	625
	,, Profit transferred		275				
		2,000	£1,525			2,000	£1,525
	To Balance b/d	1,000	625				

Notes. (i) As no value is placed on the bonus shares when received the book value of the total holding is reduced from 25s. to 12s. 6d. per share.

(ii) The shares held after the sale are carried down at cost.

From time to time companies seek to raise additional capital by offering to their shareholders new shares at a price which compares very favourably with the current

market price of their existing shares. There is thus an element of bonus given to existing shareholders in that they are able to acquire free of brokerage, stamp duty, etc., further shares in the company at less than the current market price or, if they so desire, to sell their 'rights' on the market. Where a shareholder exercises his rights by taking up the shares, the cost of the additional shares he acquires will be recorded in the relevant Investment Account in the same manner as any other purchase. If, however, the shareholder decides to sell his 'rights', it is considered that the proceeds of sale should be credited to the Investment Account in the capital column thus reducing the book value of the original holding. It will be appreciated that a 'rights' issue differs from a 'bonus' issue in that under the former, additional capital is being raised by the company and an additional amount will in future be required for dividends, so that in the market the value of the original shares should tend to fall. Although in the case of a bonus issue future distributions may be greater than in the past, it is not essential that they should be, the main purpose of the bonus issue being to bring share capital into line with the real capital employed. The issue merely converts existing profits into share capital, and gives rise to a book entry without affecting the net assets of the company.

§ 11. Tabular Ledgers

In certain businesses, considerable labour can be saved by utilising tabular ledgers, particularly where the transactions concerned are numerous and do not vary in their nature.

The following are some of the more usual forms of tabular ledgers:

(a) Bought Day Book and Ledger combined

It is sometimes possible, where accounts are settled regularly on a fixed monthly pay-day, to dispense with the bought ledger altogether by having a specially ruled form of bought day book. This type of book is used with very satisfactory results by several of the large municipalities. As invoices are received, they are filed away in alphabetical order as relating to each creditor. At the end of each month the special bought day book is written up from the invoices in alphabetical order. Under the name of each creditor particulars are inserted of all the invoices relating to his account in order of date, the amounts being entered in the detail column, and the total extended into the total column. Any returns or allowances should be deducted from the invoices to which they relate, and the amounts of the invoices entered in the day book net. When cash is paid, the amount thereof, together with the discount (if any), is posted in one sum from the credit of the cash book to the cash and discount column in the bought day book opposite to the item to which it relates. Each item in the total column is extended into the proper subsidiary column to which it refers, and the totals of these columns are posted monthly to the respective nominal accounts.

The following is a convenient ruling for the book, with a few specimen entries:

Illustration

BOUGHT DAY BOOK AND LEDGER

Date.	Invoice No.	Creditor.	Detail.	Total. Credit.	Date Paid.	C.B. Folio	Cash and Discount.	Materials	Packages	Freight.	Repairs and Renewals.	Trade Expenses
			£ s. d.	£ s. d			£ s d.	£ s d	£ s d.	£ s d	£ s. d.	£ s. d
		Aldgate & Co.										
Feb 3	1	Goods	13 0 0									
" 7	2	"	12 0 0									
" 21	3	"	5 0 0									
				30 0 0	Mar. 4	31	30 0 0	30 0 0				
		Braid & Pierce										
" 5	4	Goods	16 0 0									
" 17	5	"	8 0 0									
				24 0 0	Mar. 4	31	24 0 0		24 0 0			

(b) Rental Ledger

Where a considerable number of properties is held a rental ledger should be used, which may be ruled for the purpose of recording half-yearly, quarterly or weekly rentals. An illustration is given below of a quarterly rental ledger.

To enable this book to take its place in the system of double entry, the totals of the rent and allowances columns should be posted to the credit and debit respectively of the appropriate impersonal accounts. The total of the arrears carried forward column at any date will represent the outstanding debtors for rent.

Illustration

RENTAL LEDGER

Quarter ending.......................................

Name of Tenant.	Particulars.	Amount of Rent	Arrears brought forward.	Rent Payable.	Total	C.B. Fo.	Cash	Allowances.	Arrears carried forward

(c) Hotel Visitors' Ledger

The personal accounts for visitors at an hotel can be most conveniently recorded by means of a tabular visitors' ledger, which contains similar particulars to those furnished on the accounts rendered to visitors.

The following is a form of this ledger:

VISITORS' LEDGER

DEBITS.	1 Name.	Name	Name	Name	Name.	6 Name	7 Name	8 Name.	9 Name	10 Name.	DEBITS.	Total.
	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.		
Brought fd.	2 12 7										Brought fd	
Apartments	1 12 0										Apartments	
Board, etc.											Board, etc.	
Fires ...											Fires	
Breakfasts	7 0										Breakfasts	
Luncheons, etc.		8 0									Luncheons, etc.	
Dinners ..	15 0	10 0									Dinners	
Tea, Coffee, Milk	1 0	6									Tea, Coffee, Milk	
Wine . .	1 5 0										Wine	
Spirits		2 6									Spirits	
Beer ...											Beer	
Minerals											Minerals	
Cigars and Cigarettes											Cigars and Cigarettes	
Laundry											Laundry	
Paid out											Paid out	
Etc.											Etc	
Total £	6 12 7	1 1 6									Total £	
CREDITS.											CREDITS	
Cash											Cash	
Allowance											Allowances	
Personal Accounts											Personal Accounts	
Bal. c/f.		1 1 6									Bal. c/f.	
Total £	6 12 7	1 1 6									Total £	

Notes to Illustration.

A separate page or pages are opened for each day's transactions, and a column provided therein for each visitor, numbered with the number of his room. The amount brought forward at the commencement of the page in each column represents the balance due at the commencement of the day from the visitor concerned. When an account is settled, as in column (1) of the illustration, the cash received is entered as a credit, and there will be no balance to be carried forward to the next day's page.

Where circumstances render it desirable, the amount due at any date from a visitor can be transferred to a ledger account in the personal ledger, and in this way taken out of the visitors' ledger.

The daily totals in respect of each heading, both debits and credits, are entered in the total column on the right-hand side, and transferred to a summary ledger, from which the monthly, quarterly, or half-yearly totals, as the case may be, can be obtained. These will be utilised for the purpose of the impersonal accounts.

(d) Plant Ledger

Where there are numerous items of plant it is essential that a plant ledger be kept in order that the cost and written down value of each item can be ascertained at any time. A separate account will be kept for each machine and it is useful, for record purposes, also to record thereon expenditure on repairs. To facilitate computations of capital allowances, etc., for taxation purposes it is advantageous to provide each account with columns showing the allowances received and the written down values carried forward.

The following ruling will be found convenient:

PLANT LEDGER
WRAPPING MACHINE No. 3

Rate of Depreciation 10%. *Purchased* 1st July, 1955
Taxation Annual Allowances $9\frac{3}{8}$%. *Cost* £600

Date	Particulars	Alterations or Additions	Repairs	Total Capital Cost	Date	Provision for Depreciation	Written Down Value	Taxation Allowances Year	Inv. or Initial	Annual	W. d.v
1955		£		£	1955	£	£		£	£	£
July 1	Cost - Brown & Co.			600	Dec. 31	30	570	1956/57	120	56	544
Nov. 1	Motor Repairs - X Ltd.		25		1956 Dec 31	57	513	1957/58		51	493

Further columns may be provided to record the cumulative amount of depreciation provided for and the cost of repairs, etc., to date, in order that a complete history of the machine may be disclosed at a glance.

§ 12. Stock Exchange Transactions

It is the practice of the Stock Exchange to treat all dealings in Government securities on a cash basis. In the case of other stocks and shares, purchases and sales are made for the account, unless a special cash bargain is effected, and settlement normally takes place fortnightly, although occasionally the account covers three weeks.

A full description of all the financial books necessary for recording the transactions of a stockbroker's business, and of the machinery employed for settlements between members of the Stock Exchange, is outside the scope of this work. The books of prime entry are generally of elaborate design, providing for the proper recording of transactions so far as they affect persons, and for the collection of impersonal details into totals, for posting to the nominal accounts concerned.

The broker dealing in stocks or shares on behalf of a client either buys from, or sells to, a jobber. In obtaining a price from the jobber, he does not intimate whether he desires to buy or sell, and the quotation given consists generally of two prices differing slightly in amount. For instance, a stock might be quoted 101-101½. This indicates that the jobber is willing to buy at the lower price, or sell at the higher price.

When the transaction has been carried through, the broker sends a contract note to the client. In the case of a purchase, this is called a bought note, and shows the amount due from the client for the stock bought, plus commission at the authorised rate, the stamp duty on the transfer, the transfer fee charged by the company, and the cost of the contract stamp. In the case of a sale, it is called a sold note, and shows the amount due to the client for the stock sold, less commission and the cost of the contract stamp.

The commission or brokerage is according to the official scale, and generally takes the form of a percentage on the nominal value of the stock, or a fixed sum per share. In certain cases, a discretionary charge may be made, or the percentage may be calculated on the value of the stock.

The client's account is debited or credited, as the case may be, with the various amounts due from or to him in respect of these transactions. If the client does not wish to take up the stock or shares bought for him at the first settling day, it may be possible to carry the bargain over to the next settling day by arrangement with the broker, in which case the stocks concerned will be carried forward to the new account at the *making-up price*, and only the balance of the old account is then due to or from the client in cash. Making-up prices are fixed on the basis of prices ruling at the close of business on the previous day.

Where purchases are carried over in this manner, the old account must be credited and the new account debited with the stamp duty and transfer fee charged when the purchase was made, as these amounts are only payable if the stocks or shares are taken up.

The new account, in addition to being debited with the making-up price of the stock or shares carried over and the stamp duty and transfer fee brought down, is charged with the agreed contango, which is the consideration, in the nature of interest, payable to the broker for the accommodation, *i.e.*, for the period of the next account.

Illustration

S. Fuller enters into the following transactions with his stockbrokers:

Purchases:

On 16th July £10,000 L.N. Co. Ltd. 2nd Preference Stock at 23½. Stamp Duty, £47.

On 20th July £12,000 L.N. Co. Ltd. 4 per cent. Preference Stock at 84. Stamp Duty, £202.

On 23rd July £9,000 S. Co. Ltd. Deferred Stock at 23. Stamp Duty £42.

Sales:

On 24th July £10,000 L.N. Co. Ltd. 2nd Preference Stock at 24.

The brokers charge a commission of three-quarters per cent. on the money value of stocks. Only one commission was charged on stocks bought and sold for the same account. At the close of the account, S. Fuller carries over the remaining stocks at 83 and 23½ respectively, contango being charged at 5 per cent. per annum on the amount due, the following account being a 14-day account.

S. Fuller's account in the brokers' books, ignoring contract stamps and transfer fees is shown on page 440.

The broker's account in the client's books is, of course, the reverse of this account.

In the event of speculative transactions by a company, such as a finance company, being open on the Stock Exchange at the date of the company's Balance Sheet, the question arises as to how the liability attaching thereto should be stated.

Where a purchase of stock is carried over to a subsequent account, there is a liability on the part of the company to take up the stock, unless they sell it before the settling day, in which event the transaction will resolve itself into a settlement of differences. In the same manner, when stock has been sold which the company does not possess, and the transaction is carried forward, there is a liability on the part of the company to purchase the stock for delivery, and such purchase may have to be made at a higher rate than the price at which the stock was sold.

S. FULLER

		£ s. d.				s. d.	£ s. d.
July 16	To £10,000 L.N. Co. 2nd Pref. Stock at 23½ .	2,350 0 0		July 24	By £10,000 L.N. Co. 2nd Pref. Stock at 24 .		2,400 0 0
	,, Commission	17 12 6			,, Stamp Duty written back .		47 0 0
	,, Stamp Duty .	47 0 0	2,414 12 6				
,, 20	,, £12,000 L.N. Co 4% Pref. Stock at 84	10,080 0 0			,, Stock carried over: £12,000 L.N. Co. Pref. at 83 . .	9,960 0	
	,, Commission .	75 12 0			£9,000 S. Co. at 23½	2,115 0	
	,, Stamp Duty	202 0 0	10,357 12 0				12,075 0 0
,, 23	,, £9,000 S Co. Deferred Stock at 23	2,070 0 0			Stamp Duty on L.N. Co. and S. Co. Stocks c/d. .. .		244 0 0
	,, Commission	15 11 6					
	,, Stamp Duty .	42 0 0	2,127 11 6		Cash .		133 16 0
			£14,899 16 0				£14,899 16 0
	To Balance b/d:						
	,, £12,000 L.N. Co. Pref. at 83 ...	9,960 0 0					
	£9,000 S Co. Def. at 23½ . ..	2,115 0 0					
			12,075 0 0				
	,, Contango		23 3 2				
	,, Stamp Duty b/d. ..		244 0 0				

Note. As the L.N. Co. 2nd Preference Stock was bought and re-sold within the same account, no transfer will be executed by Fuller and the stamp duty charges must therefore be credited back

Until these transactions are closed, therefore, it is impossible to ascertain precisely the amount of any liability arising from them. Where the transaction has been closed before the preparation of the accounts, but after the date of the Balance Sheet, any loss which is found to have occurred should be provided for, and the liability can be stated precisely. Where, however, the transactions are not closed and the amount involved is material, a note should be made on the face of the Balance Sheet to the effect that there is a contingent liability in respect of transactions open on the Stock Exchange; and where a loss is expected, of which it is possible to make some estimate, a provision should be made accordingly.

§ 13. Professional Accounts

The accounts maintained by professional men present certain special features, the most important of which are dealt with hereunder:

(a) Separate Banking Accounts for Clients' and Trust Moneys

It is essential for all professional men who handle money belonging to clients to take all possible steps to ensure that there can be no danger of such moneys becoming confused with their own. This object is best attained by the maintenance of one or more special banking accounts to be used exclusively for clients' money. Although such a system is strongly to be recommended it is not obligatory, except in the case of solicitors.

Section I of the Solicitors Act, 1933 provides that the Council of the Law Society shall make rules as to the keeping by solicitors of banking accounts for clients' moneys and Section 18 (1) Solicitors Act, 1941 contains similar provisions regarding rules for banking accounts to be kept by a solicitor for trusts of which he is a sole trustee or where he is co-trustee only with a partner, clerk or servant of his. (In such circumstances the solicitor is termed a solicitor-trustee.)

The Council is empowered to take such action as may be necessary to enable them to ascertain whether or not the rules are being complied with. If a solicitor fails to comply with any of the rules, any person may make a complaint in respect of that failure to the disciplinary committee. In the case of a solicitor employed as a public officer, the above provisions as to keeping accounts do not apply so far as regards moneys received, held or paid by him in the course of his employment as such public officer.

The rules now in operation are the Solicitors' Accounts Rules, 1945, as amended by the Solicitors' Accounts (Amendment) Rules, 1959, and the Solicitors' Trust Accounts Rules, 1945, which have operated since 1st January, 1945.

The following is a synopsis of the rules referred to:

(1) Every solicitor who holds or receives clients' money or money subject to a trust of which he is solicitor-trustee, must keep a separate banking account for clients' money, or as many such accounts as he thinks fit, and a separate account for each trust of which he is solicitor-trustee.

(2) There may be *paid into* a client account (i.e., a current or deposit account at a bank in the name of the solicitor in the title of which the word 'client' appears):

(*a*) trust money;
(*b*) the solicitor's own money, as may be necessary to open or maintain the account;
(*c*) money to replace any sum which may by mistake or accident have been drawn from the account in contravention of the rules; and
(*d*) a cheque or draft received by the solicitor, which under the rules he is entitled to split, but which he does not split.

(3) Where a solicitor holds or receives a cheque or draft which includes client's money or trust money, he may split such cheque or draft, dealing with each part as if he had received a separate cheque or draft for that part. If he does not split the cheque or draft he must pay it into a client account, as stated in (2) (*d*) above.

(4) There may be *drawn from* a client account:
(*a*) in the case of client's money:
(i) money properly required for a payment to or on behalf of the client;
(ii) money properly required for or towards payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client;
(iii) money drawn on the client's authority; and
(iv) money properly required for or towards payment of the solicitor's costs *where a bill of costs or other written intimation of the amount thereof has been delivered to the client, and the client has been notified that money held for him will be applied towards or in satisfaction of such costs;*
(b) In the case of trust money:
(*a*) money properly required for a payment in the execution of the particular trust; and
(*b*) money to be transferred to a separate bank account kept solely for the particular trust.

(5) No amount shall be withdrawn from a client account which exceeds the amount held on account of the client or trust on whose behalf the cheque is drawn.

(6) It is not necessary for a solicitor to pay in to a client account coin or bank notes received from or on behalf of a client or trust which he pays out again without delay, in the ordinary course of business, to a third party, or cheques which he endorses over to the client or to a third party on his behalf, or in the execution of the relevant trust, or which he pays into a separate banking account in the name of the client or of some person named by the client.

(7) A solicitor shall *not* pay into a client account client's money held or received by him:
(*a*) which the client for his own convenience requests the solicitor to withhold from such account; or
(*b*) which is received by him for payment of a debt due to the solicitor from the client or in reimbursement of money expended by the solicitor on behalf of the client; or
(*c*) which is paid to him expressly on account of costs incurred in respect of which a bill of costs has been delivered, or as an agreed fee for business undertaken or to be undertaken.

(8) Every solicitor must keep properly written up such books of account as may be necessary:
(*a*) to show all dealings with:
(i) clients' money held, received or paid by him; and
(ii) any other money dealt with by him through a client account; and
(*b*) to distinguish such money held, received or paid by him on account of each separate client, and to distinguish such money from other money held, received or paid by him on any other account.

(9) (*a*) All dealings referred to above shall be recorded in:

(i) a clients' cash-book, or a clients' column on the credit side or debit side (as may be appropriate) of a cash-book, and

(ii) a clients' ledger, or a clients' column on the credit side or debit side (as may be appropriate) of a ledger,

and no other dealings shall be recorded in such clients' cash-book and ledger, or, as the case may be, in such clients' columns, and

(*b*) all dealings of the solicitor relating to his practice as a solicitor other than those above referred to shall (subject to compliance with the Solicitors' Trust Accounts Rules) be recorded (as may be appropriate) in such (if any) other cash-book and ledger or such (if any) other columns of a cash-book and ledger as the solicitor may choose to maintain.

(*c*) In addition to the books and accounts above referred to, every solicitor shall keep a record of all bills of costs (distinguishing between profit costs and disbursements) and of all written intimations under paragraph (4) (*a*) (iv) above delivered by the solicitor to his clients, which record shall be contained in a bills delivered book or a file of copies of such bills and intimations.

(*d*) The books required may be in loose leaf or card form and must be preserved by the solicitor for at least six years from the date of the last entry therein.

(10) The council of the Law Society may require any solicitor to produce his books of account, bank statements, vouchers, etc., for the inspection of any person appointed by the council with a view to such person making a report to the council on the results of such inspection.

Every solicitor in practice must deliver to the Law Society every year a certificate, signed by a qualified accountant, stating that the rules have been complied with. The issue to the solicitor of his practising certificate for the ensuing year is dependent upon the delivery of this accountant's certificate.

Columns for client's money and office money should be provided, not only in the cash book but also in each personal account in the client's ledger. The following entries should be made:

(1) On receipt of money from or on behalf of a client (other than money referred to in paragraph (7) above) debit 'client' column in cash book and credit 'client' column in personal account.

(2) On payment of money to or on behalf of a client for whom at least an equivalent amount of money is held, credit 'client' column in cash book and debit 'client' column in personal account.

(3) If money is paid away to or on behalf of a client in excess of the amount standing to his credit in a 'client' account, credit 'office' column in cash book and debit 'office' column in personal account.

(4) When a bill of costs is rendered to a client, debit 'office' column in personal account and credit Costs Account in impersonal ledger. (This would be done in total from the costs book.)

(5) When a transfer of cash is made from a client bank account to office bank account in payment of a bill of costs rendered to a client or other amount due to the solicitor by the client, debit 'office' column and credit 'client' column in cash book.

If the solicitor's transactions are recorded in the above manner, the balance on the client bank account at any time should be equal to the total of the balances of the 'client' columns in the personal accounts in the client's ledger. At no time can there be a *debit* balance on the 'client' columns in a personal account, since no amount must be paid to or on behalf of a client in excess of the amount standing to his credit in the client bank account.

Illustration

A B & Co. keep all moneys of clients in a separate banking account used exclusively for the purpose. At the end of each month they make any necessary transfer from 'client account' to 'office account.'

On 1st July, the balance at bank on 'Office Account' was £750, and the balance at bank on 'Client Account' was £1,055, made up of the following credit balances, *viz.*:

	£	s.	d.
D & Co.	50	0	0
X Trust	115	0	0
Z & Co.	350	0	0
J & Co., Ltd.	540	0	0
	£1,055	0	0

The receipts and payments for the month of July were as follows, all receipts being banked at once:

July 2 Received from C & Co., clients, £105 for costs as rendered.
„ 9 Paid £5 10s. for insurance premium for D & Co.
„ 9 Paid £9 for repairs to premises rented by E & Co. under X Trust.
„ 15 Paid £9 for advertisements *re* J & Co. Ltd.
„ 15 Authorised to draw £35 on account of costs *re* X trust.
„ 15 Authorised to draw £120 on account of costs *re* J. & Co. Ltd.
„ 16 Received from E & Co., £44 15s. rent under X Trust.
„ 17 Cashed cheque for £10 for K from petty cash.
„ 18 Received from F. & Co., £100 in advance on account of professional services to be rendered.
„ 18 At the request of G. & Co., paid £1 registration fees.
„ 19 Received £99 debt collected for H & Co.
„ 20 Paid H & Co. £84, being amount recovered, less costs as agreed.
„ 21 Received £45 from T & Co., being debt due to J & Co. Ltd.
„ 23 Received from D & Co. cheque for £34. 5. 0. being balance of costs as rendered (£78 15s.), plus out-of-pockets.
„ 31 Agreed costs with F & Co., at £120 and received their cheque for balance, of £20.
„ 31 Paid salaries, £240, and drew petty cash, £20.

You are required:

(*a*) To write up the Cash Book and the Clients' Ledger Accounts.

(*b*) To draw a cheque on 'Client Account' for the amount due to 'Office Account' on 31st July; and

(*c*) To bring down the balances in the Cash Book, showing the agreement of the 'Client Account' bank balance with the credit balances on the Clients' Ledger.

CASH BOOK

			Client. £ s. d.	Office. £ s. d.
July	1	To Balances b/f.	1,055 0 0	750 0 0
	2	„ C & Co. – Costs		105 0 0
	16	„ X Trust – Rent from E & Co.	44 15 0	
	17	„ Petty Cash – Cheque cashed for K .		10 0 0
	18	„ F & Co. on A/c.	100 0 0	
	19	„ H & Co. Debt collected	99 0 0	
	21	„ J & Co. Ltd. Debt from T & Co. . .	45 0 0	
	23	„ D & Co. Balance of costs and out-of-pockets . .		34 5 0
	31	„ F & Co. Balance		20 0 0
		„ Clients Account		314 10 0
			£1,343 15 0	£1,233 15 0
Aug.	1	To Balance b/d.	921 15 0	972 15 0

		Client. £ s. d.	Office. £ s. d.
	By D & Co. Insurance Premium	5 10 0	
	„ X Trust – Repairs to Premises rented by E & Co.	9 0 0	
15	„ J & Co., Ltd.–	9 0 0	
18	Advertisements .		
	„ G & Co. – registration fees paid .		
20			1 0 0
	„ H & Co. – Debt recovered, *less* costs		
31		84 0 0	
	„ Salaries .		240 0 0
	„ Petty Cash		20 0 0
20	„ Office Account	314 10 0	
	„ Balance c/d.	921 15 0	972 15 0
		£1,343 15 0	£1,233 15 0

CLIENTS LEDGER

D & CO.

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	9	To Cash Insurance Premium... ...	5 10 0		July	1	By Balance b/f ..	50 0 0	
	23	„ Costs		78 15 0	July	23	„ Cash		34 5 0
	31	„ Office Account ...	44 10 0		„	31	„ Client account		44 10 0
			£50 0 0	£78 15 0				£50 0 0	£78 15 0

X TRUST

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	9	To Cash – Repairs to premises rented by E & Co.	9 0 0		July	1	By Balance b/f.	115 0 0	
	15	„ Costs		35 0 0	„	16	„ Cash – Rent from E & Co. .	44 15 0	
	31	„ Office account	35 0 0		„	16	„ Client account		35 0 0
		„ Balance c/d .	115 15 0						
			£159 15 0	£35 0 0				£159 15 0	£35 0 0
					Aug		By Balance b/d.	115 15 0	

Z & CO.

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
					July	1	By Balance b/f.	350 0 0	

J & CO LTD

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	15	To Cash – Advertisements	9 0 0		July	1	By Balance b/f. .	540 0 0	
		„ Costs . .		120 0 0	„	21	„ Cash – Debt collected from F & Co.	45 0 0	
„	31	„ Office account .	120 0 0		„	31	„ Client account		120 0 0
		„ Balance c/d.	456 0 0						
			£585 0 0	£120 0 0				£585 0 0	£120 0 0
					Aug	1	By Balance b/d. .	456 0 0	

C & CO. LTD.

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	1	To Balance b/d		105 0 0	July	1	By Cash		105 0 0

F & CO. LTD.

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	31	To Costs		120 0 0	July				
		„ Office account .	100 0 0				future services	100 0 0	
					„	31	„ Client account		100 0 0
							„ Cash .		20 0 0
			£100 0 0	£120 0 0				£100 0 0	£120 0 0

G & CO

			Client £ s. d.	Office £ s. d.
July	19	To Cash – Registration Fees		1 0 0

H. & CO.

			Client £ s. d.	Office £ s. d.				Client £ s. d.	Office £ s. d.
July	20	To Costs		15 0 0	July	19	By Cash – debt collected	99 0 0	
		„ Cash	84 0 0		„	31	„ Client account		15 0 0
	31	„ Office account	15 0 0						
			£99 0 0	£15 0 0				£99 0 0	£15 0 0

Agreement: Balances on Clients' Accounts:

	£ s. d.
X Trust	115 15 0
Z & Co.	350 0 0
J & Co. Ltd.	456 0 0
	£921 15 0
Dr. Balance, G & Co. out of pockets	£1 0 0

Amount transferred:

	£ s. d.
Advance Costs, F & Co.	100 0 0
„ „ D & Co.	44 10 0
Costs, H & Co.	15 0 0
„ X Trust	35 0 0
„ J & Co. Ltd.	120 0 0
	£314 10 0

Note. The out-of-pocket expenses for G & Co must not be taken to reduce the credit balance held on behalf of clients, no money having been received from that firm.

(b) Treatment of Disbursements on behalf of Clients

Disbursements made on behalf of clients may be charged direct to the accounts of the clients concerned or debited to a Clients' Disbursements Account, pending the issue of a bill of costs. Whichever method is adopted, the costs or fees rendered book should record the following details in columnar form:

(i) Fees chargeable.
(ii) Disbursements on behalf of clients.
(iii) Total.

If the first method of treating disbursements is adopted, the Client's Account will have been debited already with (ii), and will now be debited with (i) only. The total of column (i) will be credited to Fees Account, column (ii) being regarded as memoranda.

When the second method is adopted, both columns (i) and (ii) will be debited to the Client's Account. The total of column (ii) will be credited to Clients' Disbursements Account, the balance on which account should now represent debtors for disbursements not yet charged up. At the end of each accounting period the balance on Clients' Disbursements Account should be analysed to ensure that no irrecoverable items are included therein.

It is sometimes the practice to credit the gross amount of the accounts rendered to clients to the Fees Account. In these circumstances the disbursements made on behalf of clients must be debited to the Fees Account in order that the fees earned may be ascertained. When this system is adopted, the Fees Account must be credited with the amount of disbursements not yet charged up, this amount being carried down to the debit of the succeeding period. The Fees Account would appear as under:

FEES ACCOUNT

			£			£
Jan	1	To Disbursements on behalf of clients b/f.	362	Jan/Dec.	By Bills Rendered	7,896
Jan/Dec.		„ Disbursements during year	1,342	Dec. 31	„ Disbursements not yet charged out c/d.	192
Dec.	31	„ Profit and Loss Account: fees transferred	6,384			
			£8 088			£8,088
Jan	1	To Balance b/d.	192			

Alternatively, the disbursements may be charged to Profit and Loss Account, the latter account being credited with the gross amount of the accounts rendered to clients. By this method, however, the credit to Profit and Loss Account may appear to be unduly large when exceptional sums have been disbursed for clients, and thus render difficult a clear appreciation of the business done by the firm.

(c) Outstanding Fees at the Balance Sheet Date

At the end of each accounting period, there will usually be a certain amount of uncompleted work in hand for which accounts have not been rendered to clients.

Before arriving at the profit or loss for the period under review, the value of this outstanding work should be taken into account, as the period in which work has been done should get the benefit of the proportionate part of the fee or at least receive credit for the cost of the work performed. It is unwise, however, to debit the clients' accounts until bills have been actually rendered, as this may very easily lead to confusion and difficulties.

The value placed upon the uncompleted work should be debited to Work in Progress Account and credited as such to the Income and Expenditure Account or to the Fees Account. In estimating the value of outstanding work, full allowance should be made for contingencies and possible reductions in accounts, and only a very conservative valuation taken into consideration.

If a special account for work in progress is not opened the amount thereof will be carried down as a debit balance on the Fees Account. The item will be shown in the Balance Sheet as an asset, under the heading of 'Uncompleted Work', or 'Work in Progress', any cash received on account thereof being shown as a deduction.

Illustration

F. Adams started in practice as a professional accountant on the 1st July. He decides to prepare accounts half-yearly, on the 30th June and 31st December, in each year.

The net fees for the first two half-years ended 31st December, and 30th June, amounted to £487 and £621 respectively, and the uncompleted work was estimated at 31st December, to be worth £126, and at 30th June, £233.

Show the Fees Account for the two periods, bringing down as a debit balance on the account the amount of uncompleted work at the end of each period.

FEES ACCOUNT

			£			£
Dec.	31	To Profit and Loss Account	613	Dec. 31	By Sundries	487
				"	" Balance for uncompleted work c/d.	126
			£613			£613
Jan.	1	To Balance b/d.	126	June 30	By Sundries	621
June	30	" Profit and Loss Account	728	"	" Balance for uncompleted work c/d	233
			£854			£854
July	1	To Balance b/d.	233			

(d) The ascertainment of profit on a cash basis

In some instances, professional men prefer to prepare their accounts on a *cash receipts basis, i.e.*, to ignore fees earned but not yet received in cash, whether an account has been rendered therefor or not. This is the normal accounting practice of barristers owing to their inability to sue for their fees. In the case of professional firms, however, it is essential that accounts be prepared first on a normal basis in order that the true results of the year's working shall be known, adjustments being made subsequently to provide against fees not yet received in cash.

A Profit and Loss Account or Income and Expenditure Account will therefore be prepared in the usual manner, and the balance shown thereby transferred to a Receipts and Expenditure Account through which the necessary adjustments will be made.

In the latter account a reserve will be made of a sum equal to the whole amount of the debtors for fees (debtors for disbursements must not be included in this provision as the intention is not to regard the debtors as bad, but merely to ignore all fees until received in cash). A further reserve will be created in respect of the value placed upon uncompleted work, or work in progress. By debiting these two reserves to the Receipts and Expenditure Account the income included in the Income and Expenditure Account which has not yet been received in cash is deleted. The reserve created at the close of the preceding year will be credited to the Receipts and Expenditure Account. Alternatively, only the net increase or decrease required in the reserve, calculated by reference to the increase or decrease in debtors and uncompleted work during the year, may be adjusted through the account.

Illustration

A, B and C are in partnership as solicitors, sharing profits as 3 : 2 : 1. The following Trial Balance is extracted from their books at 31st December, 19.... Prepare accounts for the year ended 31st December, 19..., together with Balance Sheet as at the latter date. The uncompleted work at 31st December, 19..., was valued at £1,539. Debts amounting to £356 are to be written off as bad.

Profits are to be divided between the partners on a cash basis, each partner being entitled to interest at 5 per cent. per annum on his capital.

TRIAL BALANCE, 31st December, 19

Capital Accounts:			
A			3,000
B			4,000
C			2,000
Current Accounts - Drawings:			
A		1,560	
B		1,420	
C		650	
Disbursements on behalf of clients (Balance not yet charged to clients.)		1,329	
Salaries		1,852	
Rent and Rates		850	
Printing and Stationery		356	
Postages, Telephones, etc		184	
Costs charged to clients			9,483
Work in Progress, 1st January 19		1,296	
Work in Progress Provision, 1st January 19			1,296
Clients for moneys held on their behalf			2,000
Sundry Creditors			492
Debtors Provision, 1st January 19			3,567
Debtors (include £1,400 for disbursement		5,926	
Sundry Office Expenses		1,232	
Furniture, Fittings and Library		2,800	
Cash at Bank.			
Clients' Account	2,000		
Own Account	4,283		
		6,283	
Petty Cash		100	
		£25,838	£25,838

INCOME AND EXPENDITURE ACCOUNT

Year ended 31st December, 19

	£		£
To Work in Progress, 1st January 19	1,296	By Costs charged to clients	9,483
„ Rent and Rates	850	„ Work in Progress 31st December 19	1,539
„ Salaries	1,852		
„ Printing and Stationery	356		
„ Postages, Telephones, etc.	184		
„ Sundry Office Expenses	1,232		
„ Bad Debts	356		
„ Balance, being excess of income expenditure for the year, c/d.	4,896		
	£11,022		£11,022

RECEIPTS AND EXPENDITURE ACCOUNT

Year ended 31st December, 19

				£
To Work in Progress Reserve - 31st Dec., 19		1,539	By Balance from Income and Expenditure Account	4,896
„ Debtors Reserve - 31st December, 19		4,170	„ Work in Progress Reserve - 1st January, 19	1,296
„ Balance, being 'cash' profit c/d		4,050	„ Debtors Reserve - 1st January, 19	3,567
		£9,759		£9,759
To Interest on Capital			By Balance b/d.	4,050
A	£150			
B	200			
C	100			
		450		
„ Balance:				
A one-half	£1,800			
B one-third	1,200			
C one-sixth	600			
		3,600		
		£4,050		£4,050

A, B AND C.
BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital Accounts:			Furniture, Fittings and Library		2,800
A	3,000				
B	4,000		Sundry Debtors for Fees	4,170	
C	2,000		*Less* Debtors Reserve	4,170	
		9,000			...
Current Accounts:					
A—Interest on Capital	150		Debtors for Disbursements		2,729
Share of Profit	1,800				
	1,950		Work in Progress	1,539	
Less Drawings	1,560		*Less* Work in Progress Reserve	1,539	
		390	Cash at Bank:		
B—Interest on Capital	200		Own Account	4,283	
Share of Profit	1,200		Clients' Account	2,000	
	1,400				6,283
Less Drawings	1,420		Petty Cash in hand		100
Balance to contra	£20		Current Account B—per contra		20
C—Interest on Capital	100				
Share of Profit	600				
	700				
Less Drawings	650	50			
Sundry Creditors:					
General	492				
Clients for monies held on their behalf	2,000	2,492			
		£11,932			£11,932

§ 14. Insurance Companies' Accounts

A contract of insurance is one under which, in consideration of one or more payments, called "premiums" made by the insured person to the insurer (usually a company or a Lloyd's underwriter) the insurer undertakes to pay to the insured a determinable sum of money on the happening of a specified event. This event may be one which is certain to happen (*e.g*, the death of a person or the expiration of a specified number of years), or one which is not bound to occur, but which, if it does, will result in a loss or liability being suffered by the insured. The former type of insurance is frequently termed "assurance"; the latter is a contract of indemnity, *i.e.*, one under which the insured is indemnified against loss should the specified event occur. In practice the terms "insurance" and "assurance" are often used indiscriminately to designate both types of contract.

Insurance companies may be either "proprietary" or "mutual" companies. A proprietary company is one which has a share capital, and whose profits are applied, at least in part, in the payment of dividends to its shareholders. A mutual company has no share capital and its profits belong wholly to the policyholders. In its early days it probably has to be financed by loans. Until an adequate insurance fund has been built up part of the liability under policies will be re-insured with other companies.

In relation to fire insurance, certain companies are members of the Tariff Association which fixes the rates of premium for different types of risk and a general minimum rate below which members of the association agree not to accept business. Such companies are known as tariff offices; companies which are not members of the association are known as non-tariff offices.

Under Section 4 of the Insurance Companies Act, 1958, every insurance company to which the Act applies shall, at the expiration of each financial year, prepare in the

prescribed form, a revenue account, a balance sheet, and, except where only one class of business is carried on, a profit and loss account. The Act applies to companies carrying on the following classes of business: life assurance, industrial assurance, fire insurance, accident insurance, bond investment, motor vehicle insurance and marine, aviation and transit insurance business.

'Industrial insurance business' is that under which policies are issued for small sums (*e.g.*, to cover funeral expenses), and on which the premiums are usually paid by weekly instalments. Such policies may be taken out by parents on the lives of their children, and the sums assured are limited by the Industrial Assurance Act, 1923.

'Bond investment business' is defined in the Insurance Companies Act, 1958, as the business of issuing bonds or endowment certificates by which the company, in return for subscriptions payable at periodic intervals of less than six months, contracts to pay the bond holder a sum at some future date, not being life assurance business, industrial assurance business, or sinking fund or capital redemption insurance business.

'Employers liability insurance business' means the issue of or the undertaking of liability under policies insuring employers against liability to pay compensation or damages to workmen in their employment, but does not include any business carried on as incidental only to marine, aviation and transit insurance business.

The titles of the remaining classes of insurance are self-explanatory.

The following are the forms of Account prescribed:

FORM APPLICABLE TO LIFE ASSURANCE BUSINESS

REVENUE ACCOUNT OF THE FOR THE YEAR ENDED

IN RESPECT OF LIFE ASSURANCE BUSINESS.

	Business within the United Kingdom	Business out of the United Kingdom	Total		Business within the United Kingdom	Business out of the United Kingdom	Total
Amount of Life Assurance Fund at the beginning of the year ..	£ s. d.	£ s. d.	£ s. d.	Claims under Policies paid and outstanding :—	d.	£ s. d.	£ s. d.
				By Death			
Premiums				By Maturity			
Consideration for Annuities granted..				Surrenders, including Surrenders of Bonuses ...			
				Annuities			
£ s. d.				Bonuses in Cash ...			
Interest, Dividends and Rents				Bonuses in Reduction of Premiums			
				Commission			
				Expenses of Management			
Less Income Tax thereon ..				Other payments (accounts to be specified)			
Other Receipts (accounts to be specified)				Amount of Life Assurance Fund at end of the Year, as per Third Schedule ...			

NOTE 1.—Companies having separate accounts for Annuities to return the particulars of their Annuity business in a separate statement.

NOTE 2.—Companies having both Ordinary and Industrial branches to return the particulars of the business in each department separately.

NOTE 3.—Items in this Account to be net amounts after deduction of the amounts paid and received in respect of re-assurances of the Companies' risks.

NOTE 4.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

NOTE 5.—Particulars of the new Life Assurances effected during the year of account to be appended to the above Account, showing separately, as respects business within and business out of the United Kingdom, the number of Policies, the total sums assured, the amount received by way of single premiums, and the amount of the yearly renewal premium income, the items to be net amounts after deduction of the amounts paid and received in respect of re-assurances of the Company's risks. The particulars as to yearly renewal premium income need not be furnished in respect of Industrial business.

NOTE 6.—The columns headed 'Business out of the United Kingdom' in the case of Companies having their Head Office in the United Kingdom, apply only to business secured through Branch Offices or Agencies out of the United Kingdom.

FORM APPLICABLE TO FIRE INSURANCE BUSINESS.

REVENUE ACCOUNT OF THE FOR THE YEAR ENDED 19
IN RESPECT OF FIRE INSURANCE BUSINESS.

	£ s. d.	£ s. d.		£ s. d.
Amount of Fire Insurance Fund at the beginning of the year:			Claims under Policies and outstanding	
Reserves for Unexpired risks .			Commission	
Additional Reserve (if any) . . .			Expenses of Management	
			Contributions to Fire Brigades ..	
Premiums			Other Payments (accounts to be specified)	
Interest, Dividends, and Rents	£ s. d.		Amount of Fire Insurance Fund at the end of the year as per Third Schedule:	
Less Income Tax thereon			Reserve for Unexpected risks being per cent. of	
Other Receipts (accounts to be specified)			Additional Reserve (if any)	
				£

NOTE 1.—Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.

NOTE 2.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

FORM APPLICABLE TO ACCIDENT INSURANCE BUSINESS.

REVENUE ACCOUNT OF THE FOR THE YEAR ENDED 19
IN RESPECT OF ACCIDENT INSURANCE BUSINESS

	£ s. d.	£ s. d.		£ s. d.	£ s. d.
Amount of Accident Insurance Fund at the beginning of the year:			Payment under Policies, including medical and legal expenses in connection therewith		
Reserve for Unexpired Risks			Commission		
Total estimated liability in respect of outstanding claims			Expenses of Management ..		
Additional Reserve (if any)			Other Payments (accounts to be specified) ...		
			Amount of Accident Insurance Fund at the end of the year as per Third Schedule:	£ s. d.	
Premiums ...			Reserve for Unexpired Risks being per cent. of Premium Income for the year		
Interest, Dividends and Rents			Total estimated liability in respect of outstanding claims as per Fourth Schedule (C)		
Less Income Tax thereon.			Additional Reserve (if any)		
Other Receipts (accounts to be specified)					

NOTE 1.—Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.

NOTE 2.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

FORM APPLICABLE TO EMPLOYERS' LIABILITY INSURANCE BUSINESS.

REVENUE ACCOUNT OF THE FOR THE YEAR ENDED 19 ,
IN RESPECT OF EMPLOYERS' LIABILITY INSURANCE BUSINESS TRANSACTED WITHIN THE UNITED KINGDOM

	£ s. d.	£ s. d.		£ s. d.	£ s. d.
Amount of Employer's Liability Insurance Fund at the beginning of the year:			Payment under Policies, including medical and legal expenses in connection therewith ...		
			Commission		
			Expenses of Management		
Reserve for Unexpired risks .. .			Other Payments (accounts to be specified) ...		
Total Estimated Liability in respect of Outstanding Claims			Amount of Employers' Liability Insurance Fund at the end of the year, as per Third Schedule:	£ s. d.	
Additional Reserve (if any) .. .			Reserve for Unexpired Risks, being per cent. of Premium Income for the year		
Premiums . ..					
Interest, Dividends, and Rents .	£ s. d.		Total Estimated Liability in respect of Outstanding Claims, as per Fourth Schedule (D) ...		
Less Income Tax thereon ..			Additional Reserve (if any)		
Other Receipts (accounts to be specified)					

NOTE 1.—Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.
NOTE 2.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

FORM APPLICABLE TO BOND INVESTMENT BUSINESS

REVENUE ACCOUNT OF THE FOR THE YEAR ENDED 19
IN RESPECT OF BOND INVESTMENT AND ENDOWMENT CERTIFICATE BUSINESS

	£ s. d.	£ s. d.		£ s. d.	£ s. d.
Amount of Bond Investment and Endowment Certificate Fund at the beginning of the year:			Claims under Bonds and Certificates, paid and outstanding		
Additional Reserve (if any)			Commission		
			Expenses of Management		
Premiums			Other Payments (accounts to be specified)		
Interest, Dividends, and Rents	£ s. d.		Amount of Bond Investment and Endowment Certificate Fund at the end of the year as per Third Schedule	£ s. d.	
Less Income Tax thereon .			Additional Reserves (if any) .		
Other Receipts (accounts to be specified)					

NOTE 1.—Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.
NOTE 2.—If any sum has been deducted from the Expenses of Management Account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

FORM APPLICABLE TO MOTOR VEHICLE INSURANCE BUSINESS

REVENUE ACCOUNT OF THE FOR THE YEAR ENDING 19
IN RESPECT OF MOTOR VEHICLE INSURANCE BUSINESS

	£ s. d.	£ s. d.		£ s. d.	£ s. d.
Amount of motor vehicle insurance fund at the beginning of the year:			Claims under policies paid and outstanding		
Reserve for unexpired risks .			Commission		
Additional reserve (if any).			Expenses of management . .		
			Other payments (accounts to be specified)		
Premiums			Amount of motor vehicle insurance fund at the end of the year as per Third Schedule:	£ s d.	
Interest, dividends, and rents .	£ s. d.		Reserve for unexpired risks being per cent. of premium income for the year .. .		
Less income tax thereon ..			Additional reserve (if any)		
Other receipts (accounts to be specified)					

NOTE 1.—Items in this Account to be the net amounts after deduction of the amounts paid and received in respect of re-insurances of the Company's risks.
NOTE 2.—If any sum has been deducted from the Expenses of management account, and taken credit for in the Balance Sheet as an asset, the sum so deducted to be separately shown in the above Account.

REVENU ACCOUNT nded , in respe ARINE, AVIATION AND TRANSIT INS ANCE BUSINE

ng tur ir ed ig ear ind espe in p ness arising ars). that year, (b) in the last

	Cu ren ar.	(b) Last Preceding Year.	Pre ce ear		Current Year.	Last Preceding Year.	Previous Years	To
					s. d.	£ s. d	£ s. d	£ s
Amount of l ine. anc Transit insurance gin ning of the year ..				Claims paid (l ages. R funds and R nce Re-coveries) (t):				
Premiums (less Broker count, Commission, R Re-insurances):				Risks other t ation Hu risks ..				
Risks other han Av risks .				Aviation Hu				
Aviation Hull isk				Expenses of Mar				
Other income to be sp				Other Expendit fied)				
Loss transferred t Pr Account .				Profit transferre Profit Loss Account .				
				Amount of Ma viatio Transit insura nd a of year as sho the B Sheet .				

N his adt ust ide all expen an un s bee educted from be now epar in this accou de

SECOND SCHEDULE

PROFIT AND LOSS ACCOUNT OF THE FOR THE YEAR ENDED 19 .

		£ s. d.		£ s. d.
Balance of last year's Account	£ s. d.		Dividends and Bonuses to Shareholders	
Interest and Dividends not carried to other Accounts			Expenses not charged to other Accounts	
Less Income Tax thereon			Loss realised (accounts to be specified)	
			Other payments (accounts to be specified)	
			Balance as per Third Schedule . .	
Profit realised (accounts to be specified)				
Other Receipts (accounts to be specified)				

THIRD SCHEDULE

BALANCE SHEET OF THE ON THE 19 .

LIABILITIES.	£ s. d.	ASSETS.	£ s. d.
Shareholders' Capital paid up (if any) .		Mortgages on Property within the United Kingdom	
Life Assurance Fund*:		Do. do. out of the United Kingdom	
Ordinary Branch		Loans on Parochial and other Public Rates	
Industrial do.		Do. Life Interests . ..	
Annuity Fund*		Do. Reversions . ..	
Fire Insurance Fund...		Do. Stocks and Shares . . .	
Accident Insurance Fund . .		Do. Company's Policies within their Surrender values	
Employer's Liability Insurance Fund ...		Do. Personal Security	
Bond Investment and Endowment Certificate Fund		Investments.	
Marine Insurance Fund		Deposit with the High Court (Securities to be specified)	
Sinking Fund and Capital Redemption Fund		British Government Securities	
Profit and Loss Account .. .		Municipal and County Securities, United Kingdom	
Other Funds (if any) to be specified		Indian and Colonial Government Securities ..	
		Do. Provincial Securities	
		Do. Municipal do. .	
Claims admitted or intimated but not paid†		Foreign Government Securities	
Life Assurance		Do. Provincial Securities . . .	
Fire Insurance .		Do. Municipal do.	
Bond Investment .		Railway and other Debentures and Debenture Stocks—Home and Foreign	
		Railway and other Preference and Guaranteed Stocks.	
Annuities due and unpaid† .		Do. Ordinary Stocks	
Other sums owing by the Company† (to be stated separately under each class of business) .		Rent Charges	
		Freehold Ground Rents .	
		Leasehold do. .. .	
		House Property	
		Life Interests . . .	
		Reversions	
		Agents' Balances	
		Outstanding Premiums† .. .	
		Do. Interest, Dividends, and Rents† .	
		Interest accrued but not payable†	
		Bills Receivable . .	
		Cash:	
		On Deposit .	
		In Hand and on Current Account .	
		Other Assets (to be specified) .. .	
	£		£

*Life Companies having separate annuity fund to show amount thereof separately.

†These items are or have been included in the corresponding items in the First Schedule.

NOTE 1.—When part of the assets of the Company are specifically deposited, under local laws in various places out of the United Kingdom, as security to holders of Policies there issued, each such place and the amount compulsorily lodged therein must be specified in respect of each class of business, except that, in the case of Fire, Accident, or Employers' Liability Insurance Business, it shall be sufficient to state the fact that a part of the assets has been so deposited.

NOTE 2.—A Balance Sheet in the above Form must be rendered in respect of each separate Fund for which separate Investments are made.

NOTE 3.—The Balance Sheet must state how the values of the Stock Exchange securities are arrived at, and a Certificate must be appended, signed by the same persons as sign the Balance Sheet, to the effect that in their belief the assets set forth in the Balance Sheet are in the aggregate fully of the value stated therein, less any Investment Reserve Fund taken into account. In the case of a Company transacting Life Assurance business or Bond Investment business, this Certificate is to be given on the occasions only when a statement respecting valuation under the Fourth Schedule is made.

NOTE 4.—In the case of a Company required to keep separate funds under section 3 of this Act, a certificate must be appended signed by the same persons as signed the Balance Sheet, and by the Auditor, to the effect that no part of any such fund has been applied, directly or indirectly, for any purpose other than the class of business to which it is applicable.

The Act provides that the fund of any particular class of business shall be as absolutely the security of the policy holders of that class as though it belonged to a company carrying on no other business than insurance business of that class, and shall not be applied directly or indirectly for any purposes other than those of the class of business to which the fund is applicable.

Where, however, an insurance company carries on, together with other business, an insurance business of only one of the classes to which the Act applies, or carries on, with or without other business, insurance business of two or more of the said classes, the receipts of that class of business, or of each of those classes of business, as the case may be, must be entered in a separate account and must be carried to and form a separate insurance fund with an appropriate name.

LIFE ASSURANCE

From observation of groups of persons over long periods, statistics have been prepared showing the average expectation of life of members of each of such groups. With this knowledge, it is possible to calculate what sum of money must be invested in each year to accumulate at compound interest (*i.e*, by investing each year's interest with that year's contribution to the fund), to any stated amount on the average date when a member of the group would die. The share of each member of the group in this annual sum can obviously be computed by simple division. If, therefore, the group were "assured" for a given amount to be paid to each member on the date of his death, and the contributions payable by each member were invested, year by year, at compound interest, the required sum would become available. Some members would die before the average date and contribute less than their share; others would outlive the average date and the excess contributions of the latter would compensate for the deficiency of the former. The amount payable by each individual for the insurance alone, without respect to expenses and profit, is known as "pure premium." To this there must be added a "loading" to cover (*a*) the expenses of running the business, including risks incidental thereto, and (*b*) profit.

When a person desires to insure his life, the insurers require him to complete a proposal form, showing details of his age, health, family history as regards age of death, serious ailments, etc., from which they can place him in his appropriate group and compute the premium payable for the sum for which he wishes to be assured. The insured person will pay this premium annually (or by instalments at more frequent intervals if so arranged), and on his death the company will pay the sum assured to his estate, on due proof of death and representation.

From what has been said, it should be clear that the company must retain as a fund, invested at compound interest, the pure premium portion of each payment, in order to accumulate the sums necessary to meet their ultimate liability. The "loading," however, can be used to meet expenses, pay dividends, create reserves, etc. It is also obvious that without an adequate number of assured persons in each group, the company will require considerable reserves to meet contingencies.

Where the insured person desires to share in profits, he can take out a "with profits" assurance policy, in which case a further slight increase is made in the premium for the right to participate in the profits of the business. The profits made by the company are then allocated partly to policy-holders and declared in the form of "bonuses," which are normally "reversionary bonuses," *i.e.*, amounts added to the sums assured, to be paid as an addition to the moneys payable on death. Most

companies allow such bonuses to be surrendered for a present cash payment of their present worth, *i.e.*, the sum which, invested at the date of surrender at compound interest, would produce the amount of the reversionary bonus on the date of expected death. The cash value of the bonus, can, in such cases, be applied in part payment of the premium instead of being drawn in cash.

Reversionary bonuses may be "simple," *i.e.*, always calculated on the original sum assured, or "compound," *i.e.*, calculated upon the sum assured, plus the aggregate of all previous bonuses.

When a person dies, or a policy matures between valuation dates, an 'interim bonus' is usually added for the period since the last valuation, at a rate fixed at or slightly lower than the rate declared at that valuation.

So far, only whole life assurance has been considered. A popular variation thereof is the endowment policy. A pure endowment policy is a simple investment, whereby the insured pays an annual premium for a fixed capital sum payable at the end of a stated period of years, the capital sum amounting to the total of his premiums, plus a small amount of interest. Here again, by paying an increased premium, he can share in profits. The most common type of endowment, however, combines a death benefit, the sum assured being payable at the end of the stated number of years or on earlier death. The premium is naturally higher to cover the risk of death.

Pure endowments are commonly in the form of sinking fund or leasehold redemption policies. Many variations of whole life and endowment policies are met with, but the fundamental principles in each case are the same.

It is not necessary, in a general work on Book-keeping and Accounts, to describe in detail the system of book-keeping adopted by life assurance companies. This follows ordinary double entry rules, the premiums received on policies and income from invested funds being the main income, against which are charged claims paid and expenses incurred. Most of the subsidiary records are in columnar form. It is only in the final accounts that any real difficulty arises, firstly because in the form of Revenue Account prescribed by the Insurance Companies Act, 1958, income is debited and expenditure credited (whereas in other forms of Income and Expenditure Account income is credited and expenditure debited), and secondly because profits must be computed actuarially.

It will be appreciated that as each assured person becomes older and pays more premiums, the amount that is necessary for the company to retain in the assurance fund to meet the liability to the assured correspondingly increases. The fund retained to meet the aggregate liability on all policies outstanding is termed the 'Life Assurance Fund,' and until the proper amount thereof and the liability on outstanding policies has been computed, the amount of profit cannot be ascertained.

Accordingly, Section 5 of the Insurance Companies Act, 1956, prescribes that every company which carries on life assurance business, industrial insurance business or bond investment business shall at least once in every five years cause an investigation to be made into its financial condition, including a valuation of its liabilities by

an actuary and shall cause an abstract of the actuary's report to be made on the prescribed form. Many companies make the valuation more frequently, some every year. At the quinquennial (or more frequent) valuation, actuaries prepare a consolidated revenue account (in form similar to the annual one), for the period since the last valuation, and compute what sum it would be necessary to invest at compound interest to accumulate the sums insured by their due dates, *i.e.*, the present worth of the sums assured (including reversionary bonuses). From this they deduct the present worth of the pure premiums still remaining to be paid by the assured persons. The balance is the minimum amount that the company should have invested on account of the fund if it is to remain solvent. The rate of interest to be taken into account in valuations is always a conservative estimate of the yield expected from the investment of the funds, and varies from time to time.

In the years between valuations, the excess of premiums and other income over claims and expenses is carried forward as an addition to the fund. Reference should here be made to the official form of Revenue Account reproduced on p. 552 from which it will be seen that the amount of the fund at the beginning of the period is the starting point of the account, and the amount of the fund at the end of the period the balance carried forward.

From this point onwards all explanations are made on the basis of a quinquennial valuation; if more frequent valuations are made, readers can readily supply for themselves the differences which arise, the principles being unchanged.

A Consolidated Revenue Account, covering the period from the last valuation, is prepared, summarising the items appearing in the intervening accounts, in the following form:

Consolidated Revenue Account of the.................... ....for........................years commending....................................and ending...................................

	£ s. d.	£ s. d.		£ s. d.	£ s. d.
Amount of Life Assurance Fund at the beginning of the period			Claims under policies paid and outstanding		
Premiums			By death		
Consideration for annuities granted			By maturity		
Interest, dividends, and rents			Surrenders		
Less income tax thereon			Annuities		
Other receipts (accounts to be specified)			Bonuses in cash		
			„ „ reduction of premiums		
			Commission		
			Expenses of management		
			Other payments (accounts to be specified)		
			Amount of Life Assurance Fund at the end of the period, as per Third Schedule		

Note. If any sum has been deducted from the Expenses of Management Account and taken credit for in the Balance Sheet as an asset the sum so deducted to be separately shown in the above Statement.

The profit for the quinquenium is found by means of what is called in the Insurance Companies Act a 'Valuation Balance Sheet'. This title is a misnomer; it is really a statement of affairs similar to that used in ascertaining profits from books kept by single entry.

The following is the prescribed form of Valuation Balance Sheet:

VALUATION BALANCE SHEET OF AS AT 19 .

To Net Liability under Life Assurance and Annuity transactions (as per Summary Statement provided in Fourth Schedule (A))	By Life Assurance and Annuity Funds (as per Balance Sheet under Schedule 3)
To Surplus (if any)	By Deficiency (if any) ... ..

The fund credited is that shown by the Consolidated Revenue Account, which is obviously the same as that in the annual Revenue Account prepared to the date of valuation. The estimated liability debited is the actuarial valuation of the amount necessary to meet all liabilities on policies outstanding, computed as already described. Obviously, if the actual fund exceeds the estimated liability, there is a surplus; if the reverse is the case there is a deficiency. The surplus, however, is not necessarily the true profit for the quinquennium, since it is not usual to distribute profits up to the hilt, and any profits brought forward from the previous period and not paid away in dividends or transferred to reserves will remain in the fund. The actual fund may and usually will therefore include undistributed surplus brought forward from the previous valuation. Moreover, there may have been bonuses paid away in cash or in reduction of premiums during the quinquennium, which have reduced the fund without reducing profits, and these must be added back.

Accordingly, to ascertain the true profits, the actuary will prepare a statement in the following form:

		£
Surplus, per Valuation Balance Sheet	£	
Add Interim bonuses	£	
Total Surplus	*£	
Deduct Balance brought forward from last quinquennium	£	
Surplus earned	£	

The allocation of the surplus then takes the following form:

To the Proprietors	
To the Policy Holders	
To be allotted	£
Already paid as interim bonuses	
Balance carried forward	£
Total .	*£

Transfers to Reserve or Profit and Loss or Dividend Accounts are made from the Revenue Account, thus reducing the fund. Reversionary bonuses, however, do not

* These two amounts obviously are the same.

† The reversionary bonuses, unless taken in cash at their present value, will remain in the fund as part thereof.

appear in the Revenue Account, except as part of the fund; they go to increase the sums assured and will therefore be taken into account as part of the sums assured at the next valuation.

The other items appearing in the Revenue Account will now be briefly described.

CONSIDERATION FOR ANNUITIES GRANTED

The capital sum required to produce a given income is more than the capital sum required to produce the same annual return if the capital itself is to be used up, *e.g.*, if a person requires £100 per annum from his capital for three years, he can obtain this by using the money himself in three ways:

(1) By setting aside £300 capital, without investment, and using £100 each year. In this case he uses £300 capital, but has no capital left at the end of the period:

(2) By investing £2,500 capital at 4%. In this case the capital remains intact.

(3) By investing £277 10s. 2d. at 4%, realising each year a sufficient amount of the capital to make, with the interest received, £100 per annum, *i.e.*,

Year 1 Interest £11 2s. 0d. Capital Realised £88 18s. 0d. Total £100.
,, 2 Interest (on £188 12s. 2d.) £7 10s. 11d. Capital realised £92 9s. 1d. Total £100.
,, 3 Interest (on £96 3s. 1d.) £3 16s. 11d. Capital realised £96 3s. 1d. Total £100.

In this case the capital is used up over the period.

(It would, of course, be necessary to invest more than the amount stated in (2) and (3), as income tax would be deducted from the interest. Tax has been ignored to exemplify the principle.)

If, however, he approaches an assurance company, the company will be willing to take his capital and employ it according to the third method to pay him an annuity, not for a fixed period, but for life. The company has to consider the possibility of the annuitant outliving the period of their basic calculations and the possibility of his dying earlier. The "group" principle arises again in this case, and assurance companies can offer very attractive annuities, *e.g.*, a man aged 60 who has £10,000 capital, and could invest it at 4% would receive an income of £400 (less tax) per annum, but by purchasing an annuity would, by the loss of his capital, receive about £800 (less tax) per annum. Where there are no dependents for whom provision must be made, this proposition has its attractions.

The sums received by the assurance company for the purchase of annuities come under this heading in the Revenue Account, and the actual payments of annuities are shown as "annuities" on the other "side" of the account. Here it may be mentioned that income tax is deducted from each payment of annuity, but where the annuitant is exempt from tax by reason of allowances or is chargeable at the reduced rate only, arrangements will usually be made for no tax, or only the reduced rate of tax to be deducted. In any event, since 5th April, 1956, income tax is only deductible (in the case of a purchased annuity), from a proportion thereof; the capital element contained in the payment is not subject to income tax.

In valuing annuity business, unlike life assurance, as the annuitant gets older, the liability of the company in respect of his annuity decreases, just as an annuity to a person produces a higher return for the same cost the older the annuitant is when it is purchased.

Interest, Dividends and Rents

The amounts to be included here are the income from the investments earmarked to the Life Assurance Fund only. Income from other investments must be carried to the Revenue Account(s) of the fund(s) to which they belong, or if they are not earmarked to any fund, to Profit and Loss Account. It should be noted that a company carrying on life business only will not have a Profit and Loss Account at all; it is only where more than one class of business is carried on that this account is necessary. The interest, etc., must be stated gross (inset) and the income tax shown as a deduction.

Claims

The division into claims "by death" and "by maturity" indicates the distinction between claims arising as a result of death as distinct from those arising on the expiration of the agreed periods of endowment policies.

Surrenders

Sometimes, through force of circumstances, an assured person decides to discontinue his contract, and arranges with the company to 'surrender' his policy. In such cases, the company will make a refund of a portion of the premiums paid, provided the policy has been in force for a minimum period, which varies with different types of policies.

The surrender value on a life policy is always less than the total premiums paid, except in the case of a 'with profits' policy that has been in existence for a considerable time, and in respect of which the present worth of reversionary bonuses compensates for the other factors mentioned below.

Bearing in mind the 'group' principle underlying assurance, it will be seen that where a policy-holder determines his contract, he disturbs the whole group. The company is entitled to take into account the potential benefit which would accrue from the possibility that the assured would have been one of those who outlived the average age, and to have regard to the fact that it has carried the risk of his death for the period that the policy has been in existence. Some deduction from the premiums paid is therefore proper on those accounts. Moreover, only the pure premium can be taken into account in arriving at the surrender value. The first premium is substantially absorbed by expenses, and the surrender value is usually fixed at a percentage of the premiums paid, excluding the first, with an addition for the present worth of bonuses.

In the case of sinking fund and other pure endowment policies, the circumstances are different; the real effect of these is as if the company had borrowed money, and the policy-holder invested it, at interest. The surrender value is therefore based on the premiums plus a small rate of interest.

BONUSES

These have already been explained. It should be noted that the only amounts appearing in the Revenue Account are the sums actually paid out in cash (or applied in reduction of premiums).

COMMISSION

This item is self-explanatory; it is the amount paid to agents remunerated on a commission basis.

OTHER RECEIPTS

Only income of the life business is to be included, *e.g.*, fines for renewing lapsed policies (*e.g.*, where the assured has not paid his premium within the fifteen days of grace customarily allowed, and has been 'fined' a sum of money which is in reality interest for the period of the arrears).

The notes to the Revenue Account reproduced on p. 552 should be observed.

Note 1 is self-explanatory. Many companies keep a separate account of annuities and therefore have a separate Annuity Revenue Account. Some companies keep a separate account for Sinking Fund Insurance.

Note 3. Where an assurance is made for a sum in excess of the company's limit for any one policy, the excess will be 're-insured' with other companies, or with re-insurance companies. Large insurances are commonly 'spread' in this way.

Note 4 applies principally to the early years of a company's existence, when part of the expenditure is capitalised on Development Account. It is prudent to write off such expenditure as soon as possible.

INDEMNITY INSURANCE

The principle of indemnity insurance is entirely different from that of life assurance. In an indemnity insurance the company undertakes, in consideration of a premium, to indemnify the insured if the event happens against the risk of which the policy is taken out. If the policy is for a larger amount than the actual loss, only the latter sum will be paid, whereas if the policy is for less than the loss, only the amount of the policy will be paid, subject to 'average' (*see* below). There is only one exception, *viz.*, where an agreed value is placed on the subject matter of the insurance, that amount will be paid irrespective of its value at the date of the loss, a higher premium being paid on such insurances.

The principle of averaging is important. In the case of all indemnity policies, other than marine (where the term 'average' has a special meaning) if the value of the property insured exceeds the amount of the policy, the insured is deemed to have insured himself for the excess, and in the event of a loss, only the proportionate amount of the loss is payable by the insurance company, unless there is a clause in the policy to delete average (in which case the premium will be increased).

The equity of averaging will be seen from the following simple illustration:

Illustration (1)

A trader had three shops in each of which he had a maximum stock at any time amounting to £1,000. He took out an insurance policy against loss of stock by fire, but, arguing that

the likelihood of all three shops being destroyed together was so remote, insured the whole stock for £1,000 only. Subsequently, one shop was destroyed, together with the stock therein, then worth £900.

Average would operate. The trader tried to cover three risks at the price of one, and must be considered as having himself carried the risk for two-thirds of the stock. The insurance company would therefore pay £300 only.

The Revenue Accounts required in the case of indemnity business are similar to the Life Revenue Account, except in respect of the funds. Life assurance is a continuing contract, with an increasing liability year by year on each individual policy until the sum assured falls due. Indemnity insurance continues from year to year, only so long as policies are renewed, *i.e.*, each year must be regarded separately, and the profit of each year can be separately ascertained. As the end of the period of insurance approaches, the risk gets less; in other words, the premium should be regarded as being earned on a day-to-day basis, *e.g.*, if a policy were taken out on 29th September, 1958, and a premium paid for the year ending 29th September, 1959, this premium could be considered as earned equally over the 365 days of the contract, and if the company prepared its accounts on 31st December, 1958, it should carry forward the unearned proportion applicable to the period 1st January, 1959, to 29th September, 1959, *i.e.*, 272/365ths of the premium.

To make a separate calculation in respect of each policy would not be worth while. The practice of fire insurances companies is to carry forward such a percentage of the net premium received for the year (*i.e.*, premiums received less re-insurance premiums paid) as is considered to be unearned at the date of the balance sheet. The proportion to be carried forward is determined by reference to past experience of claims, and is usually in the neighbourhood of 40 per cent., Many companies add to the amount carried forward an additional reserve for contingencies. The balance of the Revenue Account is the profit or loss on the fire insurance business for the year, and is transferred to the Profit and Loss Account.

Separate Revenue Accounts are required for each class of business. The forms applicable to Fire Insurance, Accident Insurance, Motor Vehicle Insurance, Employers' Liability Insurance, Bond Investment Business and Marine Aviation and Transit Insurance business are reproduced on pp. 553-55.

Burglary Insurance and General Insurance are frequently combined with Accident business, and only one Revenue Account is prepared for this department.

In Bond Investment business (which is an investment, not an indemnity business), the liability on outstanding policies or certificates is the difference between the present value of the sums assured (including bonuses) and the present value of the future annual premiums,

Profit and Loss Account.

As already mentioned, a Profit and Loss Account is required only where more than one class of business is carried on. Where only one class is carried on, the items appearing in the form of account reproduced on p.556 would appear in the Revenue Account. Where a Profit and Loss Account is required, the profit or loss on each

fund (in life business, the amount appropriated) is transferred from the appropriate Revenue Account to the Profit and Loss Account.

The income from investments not earmarked to any particular fund appears in the Profit and Loss Account. In other respects, this account is an Appropriation Account.

BALANCE SHEET.

Since it is most important that the various funds should be represented by realisable assets, the most important assets of an insurance company are its investments, and these are shown on the prescribed balance sheet (*see* p.556) in the order of security. In other respects the balance sheet requires no particular explanation. Student readers should note that the items 'Freehold and Leasehold Ground Rents' represent the purchase price of the right to receive ground rents, acquired by the company. The notes to the Balance Sheet should be observed.

DEPOSITS.

Prior to the passing of the Assurance Companies Act, 1946, every assurance company was required by Sec. 2, Assurance Companies Act, 1909, to deposit with the Paymaster-General a sum of £20,000 for each class of business carried on. Section 4, of the Assurance Companies Act, 1946, however, discontinued that provision and the amount deposited could be withdrawn in certain circumstances.

It is now provided by the Second Schedule of the Insurance Companies Act, 1958, that where, on the application of any association of persons, whether incorporated or not, which immediately before 25th October, 1945, was not carrying on in Great Britain insurance business of the above mentioned classes, the Board of Trade are satisfied that the association:

(*a*) is about to carry on long-term business in Great Britain; and

(*b*) is so constituted that the whole of its divisible surplus or profit must be apportioned or applied for the benefit of the policy holders (*i.e.*, that it is a Mutual Association).

the Board may order that the provisions of Section 2 of the Act (which requires a company carrying on such classes of business to have a paid up share capital of not less than £50,000) shall not apply to the association. Where such an order is made, the association must, before commencing to carry on long-term business in Great Britain, deposit with the Accountant-General of the Supreme Court in respect of each class of business, the sum of £20,000, and must keep that sum so deposited while it continues to carry on long-term business in Great Britain. The amount deposited must be invested by the Accountant-General of the Supreme Court, and shall, together with the interest accruing thereon, be deemed to form part of the fund in respect of which the deposit was made.

Section 20 of the Insurance Companies Act, 1958, provides for regulations to be made allowing an insurance company to withdraw any deposit made by it if the Board of Trade are satisfied in manner provided by the regulations:

(*a*) in the case of a company carrying on general business, whether with or without long term business, that the value of the company's assets exceeds the amount of

its liabilities by the greater of £50,000 or one-tenth of the general premium income of the company in its last preceding financial year; or

(*b*) in the case of a company carrying on long-term business but not general business, either that it has a paid up share capital of £50,000 or more, or—

(i) in the case of a company required to keep a separate fund or funds, that the value of the assets of the fund or of each such fund exceeds the amount of the liabilities to which it may be applied and that the excess or, where more than one such fund is kept, the aggregate excess, is not less than £50,000;

(ii) in the case of a company not so required, that the value of the company's assets exceeds the amount of its liabilities by £50,000.

N.B.—'General business' means assurance business to which the Insurance Companies Act, 1958, applies, other than 'long-term business'. 'Long-term business' means life assurance business, industrial assurance business and bond investment business.

Illustration (2)

The following accounts relate to a company carrying on life assurance and fire insurance business, for the year in which the quinquennial valuation of the life assurance fund is made. The Valuation Balance Sheet and the Statement of Apportionment of the Surplus are as shown hereunder. The directors propose to appropriate £700,000 of the surplus, one-fifth being allotted to the shareholders and four-fifths to the policy holders, and to carry forward the balance.

In the case of the Fire Insurance Department, the reserve for unexpired risks carried forward is computed at 50% of the premium income, and the additional reserve is increased by £10,000.

VALUATION BALANCE SHEET

	£		£
Net Liability under Assurance and Annuity transactions as per Valuation	4,060,451	By Life Assurance Fund (exclusive of £15,000 Investment Reserve) as per Balance Sheet	4,641,806
Surplus	721,355	„ Proprietors' share of Surplus for 5 years ending 31st December.	140,000
	£4,781,806		£4,781,806

APPORTIONMENT OF SURPLUS

	£
Surplus in Valuation Balance Sheet	721,355
Add Interim Bonuses paid for 5 years ended 31st December	42,515
Total Surplus as at 31st December	763,870
Deduct Balance brought forward from last quinquennium	50,890
Surplus earned for 5 years to 31st December ...	£712,980

It is proposed that £700,000 of the above surplus be divided between the proprietors and the policy holders in the proportions of one-fifth and four-fifths, and that £12,980 be left in the fund, thereby increasing the unappropriated balance to be carried forward to £63,870 as shown hereunder.

To the Proprietors			£140,000
„ „ Policy holders:			
To be allotted (as Reversionary Bonuses)	£517,485		
Already paid as Interim Bonuses	42,515		
			560,000
			700,000
Balance carried forward			63,870
			£763,870

LIFE ASSURANCE REVENUE ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 19 .

	£		£
Amount of Life Assurance Fund at the beginning of the year	4,628,490	Claims under Policies paid and outstanding	
Investment Reserve at the beginning of the year	15,000	By Death . .	199,124
Premiums (*Less* Re-insurances)	394,280	Maturity	187,789
Consideration for Annuities granted	15,221	Surrenders including Surrenders of Bonuses	18,827
Interest, Dividends and Rents (*less* Income Tax)	226,280	Annuities	18,320
Fines for Renewal of lapsed Policies	192	Bonuses paid in Cash	810
		Bonuses in reduction of Premiums	480
		Commission .	17,942
		Expenses of Management	37,727
		Re-assurance Balance Irrecoverable	1,638
		Proprietors' proportion of Quinquennial Profit	140,000
		Investment Reserve Fund at end of year	15,000
		Amount of Life Assurance Fund at end of year	4,641,806
	£5,279,463		£5,279,463

FIRE INSURANCE REVENUE ACCOUNT

					£
Amount of Fire Insurance Fund at the beginning of the year:			Claims paid and outstanding		468,400
Provision for unexpired risks	£452,040		Commission .		139,384
Additional Reserve	760,000		Expenses of Management .		276,955
			Overseas Taxes		1,530
		1,212,040	Transferred to Profit and Loss Account		54,066
Premiums		887,080	Amount of Fund at end of year.		
Interest, Dividends and Rents (*less* Income Tax)		54,755	Provision for unexpired risks	£443,540	
			Additional Reserve	770,000	
					1,213,540
		£2,153,875			£2,153,875

PROTECTOR INSURANCE COMPANY

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER 19

	£			
Interest, Dividends and Rents (Gross)	218,100	United Kingdom Taxation based on the profits included in this account:		
Transferred from Fire Revenue Account	54,066	Profits Tax .	£17,280	
Transfer Fees	104	Income Tax	13,620	
One-fifth of Members' Portion of Quinquennial Life Profits	28,000	Income Tax deducted from Investment Income	103,500	
				134,400
		Expenses not charged to other accounts		32,400
		Subscriptions to Charities		1,800
		Losses on Investments realised		1,500
		Profit for year, carried down		130,170
	£300,270			£300,270
		Transferred to Staff Pensions Fund		15,000
Balance of last year's Account, brought forward	142,100	Provision for Dividends payable (*less* Income Tax)		65,000
Profit for year	130,170	Balance carried forward		192,270
	£272,270			£272,270

PROTECTOR INSURANCE COMPANY LTD.

Balance Sheet as at 31st December, 19

	Authorised £	Issued and Fully paid £		£	£
Shareholders' Capital:					
5% Preference Shares of £1 each	250,000	250,000	Fixed Assets:		
Ordinary Shares of £1 each ...	1,000,000	500,000	Office Premises, at cost, less amounts written off		60,000
	£1,250,000	750,000			
Reserves:					
General Reserve	1,500,000				
Contingency Reserve ...	200,000		Investments:	1,871,760	
Members' Portion of Life Profits Accounts	112,000		Mortgages	529,090	
			Loans	2,877,530	
Profit and Loss Account	192,270		British Government Securities	2,854,479	
		2,004,270	Other Investments		8,132,859
		2,754,270			
Amount Set Aside for Future Taxation		15,000	Current Assets:		
Policyholders:			Agents' Balances and Sundry Debtors	345,970	
Life Assurance Fund	4,641,806		Amounts due from other Insurance Companies	126,250	
Fire Insurance Fund	1,213,540	5,855,346	Interest and dividends accrued (less Income Tax) ...	72,170	
Current Liabilities:			Tax Reserve Certificate	15,000	
Claims admitted or intimated but not paid	169,800		Cash—On Deposit, in hand and on Current Account	136,890	696,280
Annuities due and unpaid. ..	400				
Sundry Creditors ...	29,323				
Provision for Dividend (after deduction of Income Tax) ...	65,000	264,523			
		£8,889,139			£8,889,139

Notes: (1) The above Profit and Loss Account and Balance Sheet are in the forms adapted for publication and comply (except as regards comparative figures, which have been omitted) with the requirements of Part III, of the Eighth Schedule of the Companies Act, 1948, with regard to assurance companies, which are subject to and comply with the requirements of the Insurance Companies Act, 1958, as respects the preparation of and deposit with the Board of Trade of Balance Sheets and Profit and Loss Accounts in the forms prescribed by those Acts, as set out on pages 275-286.

(2) The items on the assets side of the Balance Sheet representing Outstanding Premiums, Outstanding Interest, Dividends and Rents and Interest accrued but not payable are included in the debits for Premiums, Interest, Dividends and Rents in the Revenue Accounts and Profit and Loss Account, which represent the total amounts accruing during the year. Similarly, the items on the liabilities side of the Balance Sheet for claims admitted but not paid, annuities due and unpaid and expenses of management due are included in the credits under these headings in the Revenue Accounts.

(3) Only so much of the surplus on the Life Assurance Fund as has actually been paid away in *cash* bonuses or allowed in reduction of premiums is credited to the Revenue Account. The proportion of the surplus to be allotted as reversionary bonuses is left in the fund, as it increases the liability on the policies.

(4) The £140,000 of the surplus allotted to the shareholders represents their share of the profit on the life assurance business for five years, and is credited to Revenue Account. Only one-fifth of this amount, £28,000, is taken to Profit and Loss Account for the current year, the balance of £112,000 being carried forward in the Balance Sheet as a reserve, to be spread over the next four years.

(5) In the case of the Fire Insurance Department, the balance of the Revenue Account, after carrying forward the amounts of the Fund at 31st December, represents the profit for the year, and is transferred to General Profit and Loss Account, thus becoming available for distribution as dividends.

§ 15. Treatment of Scrip Profits, etc.

In the case of finance companies which are concerned with the promotion and flotation of other companies, a substantial portion of the consideration for sale often takes the form of shares in the new company allotted as fully paid up. In many cases the shares so obtained are not quoted on the Stock Exchange, or, if so quoted, the price may be an artificial one having no relation to their actual value. The best method of recording these transactions in the books of the finance company is to regard the excess of the expenditure incurred on the promotion over the amount of the consideration received in cash as being the cost of the shares taken in satisfaction of the remainder of the consideration, and to bring them into account at that value. If the shares are not worth their cost, provision should be made accordingly.

When any of the shares are sold, the profit or loss on realisation should be adjusted. In these transactions, only realised profits should be distributed as cash dividends, due regard being had to the adequacy of the provisions against possible loss on realisation of the shares remaining unsold.

An alternative method is to bring these shares into account at their par value, and to have two columns in the Profit and Loss Account, one relating to cash and the other to scrip. The balance on the cash column will show the cash profit or loss during the period, and the balance on the scrip column the profit or loss on the shares. In cases where it is proposed to distribute a scrip dividend, this method is certainly the most suitable.

In any event the manner in which these shares have been dealt with should be clearly disclosed by the accounts.

Illustration

A finance company underwrote part of a new issue of shares, about to be made to the public by Wyezed Ltd. The issue was of 100,000 £1 shares, payable 2s. on application, 8s. on allotment, and 10s. one month later. The finance company underwrote 60%, and applied 'firm' for 20,000 shares which were duly allotted. The public applied for and were allotted 50,000 shares. The finance company had deposited with the underwriting letter a cheque for the application money on the shares underwritten, and this cheque was cleared by Wyezed Ltd. on the result of the issue becoming known. The underwriting commission was 1% in cash and ½% in shares, and was duly discharged.

The finance company sold 500 shares, when 10s. paid, at 9s. 9d. each, and duly paid the sums due on the balance, afterwards selling 15,000 shares at 19s. 6d. each. On their balance sheet date the shares were quoted at 19s. 9d. Write up the Underwriting Account in the finance company's books, carrying down as a reserve on the account any profit made, or writing off any loss.

UNDERWRITING WYEZED LTD. ACCOUNT

	Shares	£	s.	d.		Shares	£	s.	d.
To Cash, Application money, 2/- per share .	20,000	2,000	0	0	By Cash, Commission 1% on 60,000		600	0	0
„ Cash, on shares taken up under underwriting agreement (2/- per share paid on 60,000)	18,000	6,000	0	0	„ Contra, ½% Commission received in shares				
„ Cash, Allotment money : £ £ 8/- per share on 20,000 .. 8,000 8/- per share on 18,000 ... 7,200 *Less* Overpaid on application 2/- per share on 60,000 - 18,000 ... 4,200 3,000		11,000	0	0	„ Cash, 500 shares 10/- paid, sold at 9/9 each	500	243	15	0
„ Contra, shares (fully paid) received as commission	300				„ Cash, 15,000 shares fully paid sold at 19/6 each	15,000	14,625	0	0
„ Cash, Balance due 10/- per share on 37,500 shares		18,750	0	0	„ Balance c/d.	22,800	22,264	4	7
					„ Profit and Loss Account—Loss to date		17	0	5
	£38,300	£37,750	0	0		£38,300	£37,750	0	0
To Balance b/d.	22,800	22,264	4	7					

NOTES.

(1) There is no point in attributing a value to the shares received as commission, but they must be brought in as part of the total holding by being entered in the shares column, without any value being extended.

(2) The whole underwriting and firm application are part of a single transaction. Accordingly, the commision goes to reduce the cost of the shares to the underwriters.

(3) The underwriters applied firm for 20,000 shares and the public applied for 50,000, leaving 30,000 shares not applied for, of which the company must take up 60 per cent, or 18,000 shares, under the underwriting contract.

(4) The balance may be valued in several ways, *e.g.*,

(*a*) Ascertain what the balance would have been had no shares been sold and take a proportion thereof appropriate to the shares remaining :

		£
38,000 shares, £1 paid		38,000
300 „ received, fully paid		
38,300		38,000
	Less Commission in Cash	600
	Cost of 38,300 shares	£37,400

Value of balance $\frac{22,800}{38,300}$ of £37,400	£22,264	4
Showing a loss of .	£17	0

(*b*) Since the shares are held for resale, the lower of cost or market value may be taken Market value is 19/9, *i.e.*, a total of £22,515. Since this exceeds cost, it must be disregarded in this case.

§ 16. Accounts of Containers

Since the cost of cases, crates and other containers in which goods are packed for delivery is often considerable, it is important that a proper system of control in respect thereof should be in force. The method to be adopted for recording containers must depend on whether or not they are charged out to customers and, if so, whether or not credit is given for them when they are returned.

When containers are not returnable the charge therefor is included in the price of the goods sold, and any profit made on the containers will automatically be included in the profit on the sale of goods.

Where, however, containers are returnable, the charges made in respect thereof should be debited to customers' accounts when the containers are sent out, and the appropriate amounts credited thereto when they are returned.

The following methods of treatment are suggested:

(a) Containers charged out to Customers.

The cost of containers purchased should be debited to a Containers Account (or Containers Stock Account) which should also be debited with the value of any stock of containers brought forward from the previous period, and credited with the stock carried forward at the end of the period.

The sales day book should contain a special column for containers, in which the charges made for containers should be entered. These amounts should be debited to the personal accounts of the customers concerned and credited in total periodically to a Containers Suspense (or Containers Charged-out) Account. Particulars of containers returned by customers should be entered either in a special column in the returns inwards book or in a separate containers returned book, from which postings should be made to the credit of the personal accounts, and in total to the debit of the Containers Suspense Account.

The balance remaining on the Containers Suspense Account at any time will represent the total of the amounts charged out in respect of returnable containers still in customers' hands, and included in the debit balances on the personal accounts of customers. For balance sheet purposes, therefore, this amount should be deducted from the figure of sundry debtors. The containers in customers' hands should then be included, at cost, less depreciation, in the value of the stock of containers at the close of the period which is credited and carried forward in the Containers Account.

The amount carried down in the Containers Suspense Account and deducted from debtors should not include the value of any containers in customers' hands in respect of which the period within which their return is permissible has expired. These may be regarded as having been sold, and the amount at which they have been credited to the Containers Suspense Account should be transferred to the credit of Containers Account.

Sometimes the credit given on the return of containers is either greater (to induce their return) or less than the price at which they are charged out. Where it is greater, the debits to the Containers Suspense Account in respect of containers returned by customers, and of the containers still in customers' hands at the end of the period, will be greater than the amounts credited to that account when the containers were charged out. The resultant debit balance on the account represents an expense to the business, which should be transferred to the debit of Containers Account.

Conversely, where the credit given for containers returned is less than the amount charged out, an immediate profit is made on each such container. Only the amount to be credited to customers in respect of outstanding containers should be debited and carried forward in the Containers Suspense Account, the profit on the containers sent out being transferred therefrom to the credit of Containers Account.

In either case, the balance remaining on Containers Account, after carrying forward at valuation the closing stocks of containers on hand and in customers' hands, will be transferred to Profit and Loss Account.

Illustration (1)

A manufacturing company sells goods in cases which it purchases for 10s. each. The cases are charged out to customers at 12s. each and credited, if returned within six months, at 8s. each. All cases are valued at stocktaking at 6s. each.

The stock in the warehouse on January 1st, was 4,000 cases, and 8,400 cases, for which the return period had not expired, were in the hands of customers. During the year ended December 31st, 6,000 cases were purchased, 12,800 sent out to customers, 9,200 were

returned, 120 were destroyed in the warehouse and 200 were sold as firewood for £10. In respect of 7,600 of the cases in the hands of customers on December 31st, the return period had not expired; the remaining cases sent to customers were retained by them.

Show the ledger accounts in the firm's books in respect of cases for the year ended December 31st.

CASES STOCK ACCOUNT

		Quantity	£			Quantity	£
Jan. 1	To Stocks in Warehouse ...	4,000	1,200	Dec. 31	By Cases Destroyed ...	120	
	Stocks with Customers at 6s. per case ...	8,400	2,520		„ Cases Sold ...	200	10
	Purchases at 10s. per case	6,000	3,000		„ Cases Suspense Account: Profit of 4s. per case on 12,800 cases sent to Customers ...	—	2,560
	Profit and Loss Account: Net profit on cases ...	--	1,714		Cases retained by Customers at 8s. per case ...	4,400	1,760
					„ Stocks in Warehouse	6,080	1,824
					„ Stocks with Customers at 6s. per case ...	7,600	2,280
		18,400	£8,434			18 400	£8,434

CASES SUSPENSE ACCOUNT

		Quantity	£			Quantity	£
Dec. 31	To Cases Stock Account: Profit of 4s. per case on 12,800 cases issued to Customers		2,560	Jan. 1	By Balance b/d: Cases in Customers' hands at 8s	8,400	3,360
	„ Cases Stock Account: Cases retained by Customers at 8s. per case . ..	4,400	1,760	Dec. 31	„ Sundry Debtors: Cases charged to Customers at 12s per case	12,800	7,680
	„ Sundry Debtors: Cases returned by Customers at 8s. per case	9,200	3,680				
	„ Balance: Provision for Cases in Customers' hands at 8s. per case	7,600	3,040				
		21,200	£11,040			21,200	£11,040

An alternative method, where returnable cases are charged out to customers at a price in excess of cost, is analogous to the system described in Chapter X, Section 3 (*c*) for Branch Accounts, where goods are charged by head office to branches at a fixed percentage above cost.

Under this system the following accounts are required:

Containers Stock Account

Containers sent to Customers Account

Containers Suspense (or Adjustment) Account

Provision for Depreciation on Containers Account

Profit and Loss on Containers Account.

Containers sent out are debited to Containers sent to Customers Account at the full invoiced price, Containers Stock Account being credited with the cost price and Containers Suspense Account with the 'loading'. These entries are reversed in respect of containers returned by customers. The balance on the Containers sent to Customers Account at any time will thus represent the invoiced price of containers in customers hands, and the balance on the Suspense Account the profit loading included therein. The balance carried down in the Suspense Account will accordingly be set off against

the balance carried down in the Containers sent to Customers Account to give the cost price of containers in customers' hands for balance sheet purposes, whilst the balance of the Containers Stock Account, after adjustment has been made for any containers scrapped, will be the cost price of containers in stock.

In respect of any containers retained by (*i.e.*, sold to) customers it will be necessary to debit the customers' personal accounts and credit the Containers sent to Customers Account with the full invoice price, and to transfer from the Containers Suspense Account to the credit of Profit and Loss on Containers Account, the profit included in such price.

Depreciation on the containers in stock and in customers' hands will be debited to Profit and Loss on Containers Account and credited to the Provision for Depreciation on Containers Account, the balance on the latter account being deducted from the cost price of the cases for the purposes of the balance sheet.

Illustration (2)

Containers costing £1 each are charged out at 30s. each, credit being given for the full invoiced price when the containers are returned. For balance sheet purposes all containers are valued at 10s. each.

On January 1st there were 1,000 containers in stock and 3,700 in customers' hands. During the year ended 31st December, 5,000 containers were purchased, 7,000 were sent out and 5,200 returned. 200 containers were scrapped, the proceeds of sale being £20.

The cost of repairs to containers during the year was £50. At 31st December, 500 of the containers in customers' hands were no longer returnable.

CONTAINERS STOCK ACCOUNT

		Quantity	£			Quantity	£
Jan. 1	To Balance b/f.. Stock in hand (cost)	1,000	1,000	Dec. 31	By Containers sent to customers (cost)	7,000	7,000
Dec. 31	,, Purchases (cost)	5,000	5,000		,, Profit and Loss on Containers Account – cost of containers scrapped	200	200
	,, Containers returned by customers (cost) ..	5,200	5,200		,, Balance c/f.: Containers in stock (cost)	4,000	4,000
		11,200	£11,200			11,200	£11,200
Jan. 1	To Balance b/f.	4,000	4,000				

CONTAINERS SENT TO CUSTOMERS ACCOUNT

		Quantity				Quantity	£
Jan. 1	To Balance b/f.: Containers in customers' hands (invoiced price)..	3,700	5,550	Dec. 31	By Containers returned (invoiced price) . ..	5,200	7,800
Dec. 31	,, Containers sent out (invoiced price).. . ..	7,000	10,500		,, Sundry Debtors, containers sold (invoiced price) .	500	750
					,, Balance c/f : Containers in customers' hands (invoiced price)..	5,000	7,500
		10,700	£16,050			10,700	£16,050
Jan. 1	To Balance b/f.	5,000	7,500				

CONTAINERS SUSPENSE ACCOUNT

		Quantity	£			Quantity	£
Dec. 31	To Containers returned by customers - loading of 10s. ..	5,200	2,600	Jan. 1	By Balance b/f.: Loading on containers in customers' hands.	3,700	1,850
	„ Profit and Loss Account - profit on containers sold	500	250	Dec. 31	„ Containers sent to customers–loading of 10s	7,000	3,500
	„ Balance c/f.: Loading on containers in customers' hands ..	5,000	2,500				
		10,700	£5,350			10,700	£5,350
				Jan. 1	By Balance b/f. . .	5,000	2,500

PROFIT AND LOSS ON CONTAINERS ACCOUNT

Dec. 31	To Containers Stock Account – cost of containers scrapped . ..	200	Dec. 31	By Cash – Proceeds of scrap	20
	„ Cash - repairs to containers ..	50		„ Containers Suspense Account - profit on sales	250
	„ Provision for Depreciation on containers	2,150		„ Profit and Loss Account – Net charge for containers	2,130
		£2,400			£2,400

PROVISION FOR DEPRECIATION OF CONTAINERS

					£
Dec. 31	To Balance c/f. (9,000 at 10s.) .	4,500	Jan. 1	By Balance b/f. (4,700 at 10s.) .	2,350
			Dec 31	„ Containers Suspense Account· Depreciation for year	2,150
		£4,500			£4,500
			Jan. 1	By Balance b/f.	4,500

For Balance Sheet purposes, containers will appear as follows:

	Number		£
Containers in Stock, at cost ..	4,000		4,000
Containers in customers' hands ..	5,000	£7,500	
Less Balance on Suspense Account		2,500	
			5,000
			9,000
Less Provision for Depreciation			4,500
			£4,500

(b) Containers not charged up

Special columns should be ruled in the ledger to record the identification number of each container sent out but not charged up. The number should be entered on the invoice, and in the day book, and reference thereto made in the containers number column on the debit side of the particular account in the ledger, at the time when the posting of the sale is made.

When containers are returned, full particulars thereof should be recorded by the gate office foreman. It will not be necessary, however, to send out credit notes, nor will any entries be made in the containers journal. The gate office foreman's book should be called over with the various accounts in the ledger, and, as each entry is checked, the particular number of the package should be entered in the containers number column, on the credit side of the ledger account.

The ledger clerk should examine periodically the container number columns in the ledger, and cross out the numbers corresponding on the debit and credit sides. The remaining numbers should then represent the containers still in the hands of customers.

Proper stock accounts should be kept for the containers, and the balances of these accounts should show at a glance particulars of the containers in the factory, in the hands of customers charged up, and in the hands of customers not charged up. The stocktaking should be carried out without reference to these stock accounts, and compared with the balances on the stock accounts, any discrepancy being enquired into.

A Containers Account will be kept in the ledger, and any difference thereon, after adjusting opening and closing stocks brought in at cost less depreciation, will be written off to Profit and Loss Account in the usual way.

§ 17. The Accounts of Building Societies

A building society incorporated under the Building Societies Acts, 1874 to 1939, is established with the object of raising capital out of which advances may be made to members upon the security of mortgages on freehold or leasehold property. The capital is raised by means of paid-up or subscription shares which are withdrawable at short notice. Interest is paid on the shares at a rate which is changed from time to time so that it moves in step with the market long-term rate of interest.

Deposits are also accepted, again subject to withdrawal upon short notice, but a slightly lower rate of interest is paid on them than on shares. Both rates of interest are described as 'tax paid' as a result of the arrangement entered into between the building societies and the Inland Revenue. Not more than £5,000 may be invested in any one society by any person, husband and wife being treated as one for this purpose.

In addition to these funds obtained from investors, building societies also have their own internal reserves built up out of undistributed income in the past. The total funds of a society are utilized mainly in making advances on the security of land and buildings. Usually, these mortgages are repayable with interest by equal monthly or other periodic instalments over a specified term of years. Most societies also hold part of their funds in the form of investments in gilt-edged securities, cash at bank, and office premises.

The accounts of a building society must be prepared in a statutory form and a copy sent to the Registrar of Friendly Societies within fourteen days after the annual general meeting in each year. A specimen of the accounts of a building society in the statutory form will be found in the Appendix. It will be seen that separate accounts must be shown for shares, deposits, mortgages, investments and for the various reserve funds and reserve accounts maintained.

In the case of shares and deposits, the accounts are credited with the amounts invested by shareholders and depositors and debited with withdrawals. At the end of each year the total amounts of interest and dividends payable to shareholders and depositors are credited to the relevant accounts, interest on deposits being debited to Profit and Loss Account and dividends on shares to Appropriation Account.

The total of the sums advanced to borrowers on mortgage is debited to Mortgages Account, which is also debited with interest charged, survey fees, etc. (Profit and Loss Account being credited), and credited with repayments and other sums received. The balance of the account represents the total amount of mortgages outstanding.

Under the revised form of accounts, which came into operation in December 1956, particulars must be given of loans to borrowers who have more than one mortgage, where the total indebtedness exceeds £25,000, and also the number and amount of shareholdings and deposits greater than £5,000, the accounts must also show:

(i) the cost of advertising, the total receipts from fines and the aggregate of 'other amounts paid by borrowers as consideration for advances' as separate items.

(ii) A division of investments in British local government securities between 'quoted' and 'unquoted' investments.

(iii) The periods covered by appropriations and provisions for income tax and profits tax.

(iv) The amount of the special reserve (as distinct from a general reserve) created for anticipated mortgage losses.

PROFIT AND LOSS ACCOUNT
OF IMPERIAL CHEMICAL INDUSTRIES LIMITED
FOR THE YEAR ENDED 31st DECEMBER 1957

1956 £	1956 £			£	
291,548,328		**SALES** to External Customers and to Subsidiaries			310,646,516
38,203,149		**MANUFACTURING and TRADING PROFITS** *less* **LOSSES** after charging the items inset below			46,680,491
	18,381,519	Depreciation		19,223,440	
	5,120,835	Contributions to Pension Funds, Pensions and Gratuities (Note 1) .		,130,590	
	40,173	Audit Fees and Expenses		40,764	
2,424,435		Revenue from Subsidiaries			2,844,734
1,830,142		Revenue from Associated Companies			2,043,616
141,526		Revenue from Marketable Investments and other Securities			220,163
178,988		Interest and Miscellaneous Income			406,623
42,778,240					52,195,627
2,155,829		*Less:* Fixed Loan Interest		3,909,364	
251,111		Other Loan Interest		198,217	
2,406,940					4,107,581
40,371,300					48,088,046
2,928,892		*Less:* Provision in respect of Employees' Profit-Sharing Scheme			4,772,690
37,442,408		INCOME BEFORE TAXATION			43,315,356
18,149,269		*Less:* Taxation provided on the basis set out in Note 2 .			21,173,562
£19,293,139		INCOME OF IMPERIAL CHEMICAL INDUSTRIES LTD. FOR THE YEAR AFTER TAXATION .			£22,141,794
		RETAINED IN THE BUSINESS			
		CAPITAL RESERVES			
7,000,000		Replacement of Assets	7,000,000		
2,500,000		General	1,500,000		
9,500,000				8,500,000	
		REVENUE RESERVES			
750,000		Stock Replacement (Transfers from)	*2,500,000*		
1,348,898		General	5,220,584		
598,898				2,720,584	
10,098,898					11,220,584
		NET DIVIDENDS PAID AND PROVIDED			
		Paid			
484,564		(a) 5% Cumulative Preference Stock, half-year to 30th June 1957	484,564		
3,290,045		(b) Ordinary Stock, Interim Dividend 4% ..	3,317,360		
3,774,609				3,801,924	
		Provided			
484,564		(a) 5% Cumulative Preference Stock, half-year to 31st December 1957	484,564		
4,935,068		(b) Ordinary Stock, Final Dividend 8%	6,634,722		
5,419,632				7,119,286	
9,194,241					10,921,210
£19,293,139					£22,141,794

GROUP PROFIT AND LOSS ACCOUNT
OF IMPERIAL CHEMICAL INDUSTRIES LIMITED AND 90 SUBSIDIARIES
FOR THE YEAR ENDED 31st DECEMBER 1957

(1956 figures cover ICI Ltd and 91 subsidiaries)

1956 £		£	£
435,318,680	SALES to External Customers		462,887,826
53,445,008	**MANUFACTURING and TRADING PROFITS** *less* **LOSSES** after charging the items inset below		61,515,178

1956 £		£
23,459,049	Depreciation	24,484,572
7,106,298	Contributions to Pension Funds, Pensions and Gratuities (Note 1)	7,217,698
108,847	Audit Fees and Expenses . .	111,194

1956 £		£	£
2,621,523	Revenue from Associated Companies		3,000,594
304,630	Revenue from Marketable Investments and other Securities		376,455
378,551	Interest and Miscellaneous Income		607,686
56,749,712			65,499,913
2,957,883	*Less:* Debenture and Fixed Loan Interest	4,764,563	
523,747	Other Loan Interest .	641,760	
3,481,630			5,406,323
53,268,082			60,093,590
3,146,643	*Less.* Provision in respect of Employees' Profit-Sharing Scheme		4,958,294
50,121,439	**INCOME BEFORE TAXATION**		55,135,296
23,764,834	*Less:* Taxation provided on the basis set out in Note 2 . .		26,328,078
£26,356,605	**INCOME OF THE GROUP FOR THE YEAR AFTER TAXATION**		£28,807,218
	RETAINED IN THE BUSINESS		
	By Subsidiaries		
1,055,449	Applicable to Minority Members	785,838	
4,878,598	Applicable to Imperial Chemical Industries Ltd.	4,692,552	
10,098,898	By Imperial Chemical Industries Ltd. .	11,220,584	
16,032,945			16,698,974
	NET DIVIDENDS PAID AND PROVIDED		
1,129,419	By Subsidiaries to Minority Members	1,187,034	
9,194,241	By Imperial Chemical Industries Ltd. to its Members	10,921,210	
10,323,660			12,108,244
£26,356,605			**£28,807,218**

BALANCE SHEET
OF IMPERIAL CHEMICAL INDUSTRIES LIMITED
AT 31st DECEMBER 1957

1956 £	ASSETS, *Less* CURRENT LIABILITIES	£		
	FIXED ASSETS			
370,864,353	Property, Plant and Equipment		418,781,143	
74,862,858	*Less*. Depreciation and amounts written off		92,615,734	
296,001,495	Net Book Value (Note 3)		326,165,409	
15,153,884	Goodwill, Patents, Trade Marks, etc at cost *less* amounts written off		15,441,188	
311,155,379				341,606,597
54,397,277	INTERESTS IN SUBSIDIARIES (Note 4)			57,780,883
7,225,314	INTERESTS IN ASSOCIATED COMPANIES (Note 5)			7,795,432
	CURRENT ASSETS			
68,416,704	Stocks at or under cost		73,311,651	
36,753,944	Debtors, including Housing and other Loans (Note 6)		43,148,159	
977,742	Marketable Investments (Market value £1,420,150)		914,094	
3,000,000	Tax Reserve Certificates		4,000,000	
2,857,554	Cash at Bankers and in hand		7,067,056	
112,005,944			128,440,960	
	Less: CURRENT LIABILITIES	£		
30,747,604	Creditors	32,827,367		
37,607,443	Provisions for Taxation and other Liabilities	37,235,466		
600,714	Bank Overdraft: Secured	600,714		
5,832,830	Bank Overdrafts, Unsecured			
74,788,591			70,663,547	
37,217,353				57,777,413
£409,995,323				£464,960,325

FINANCED AS FOLLOWS:

1956 £	CAPITAL AND RESERVES	in Shares of £1 each		Issued and converted into Stock
	Capital	£		£
33,708,773	5% Cumulative Preference	33,708,773		33,708,773
143,045,436	Ordinary	144,233,090		144,233,090
	Unclassified	42,058,137		-
176,754,209		£220,000,000		177,941,863
	Reserves employed in the business (Note 7)			
115,149,547	Capital		122,171,305	
45,013,447	Revenue		48,879,367	
160,162,994				171,050,672
336,917,203				348,992,535
	FUTURE UNITED KINGDOM INCOME TAX			
11,949,000	Reserve for estimated liability 1958/59		13,224,000	
11,009,000	Reserve for deferred liability due to initial allowances		12,703,000	
22,958,000				25,927,000
	UNSECURED LOANS			
120,120	4% Loan Repayable by 1958		40,790	
20,000,000	4% Stock Repayable 1958/60		20,000,000	
30,000,000	4½% Stock Repayable 1972/74		30,000,000	
	5½% Convertible Stock Repayable 1977/79		40,000,000	
50,120,120				90,040,790
£409,995,323				£464,960,325

J. H. COTTON, *Treasurer*.

S. P. CHAMBERS, P. T. MENZIES } *Directors*.

GROUP BALANCE SHEET

OF IMPERIAL CHEMICAL INDUSTRIES LIMITED AND 90 SUBSIDIARIES

AT 31st DECEMBER 1957

(1956 figures cover ICI Ltd. and 91 subsidiaries)

1956				
£	**ASSETS,** *Less* CURRENT LIABILITIES			
	FIXED ASSETS		£	
467,419,761	Property, Plant and Equipment . . .		527,807,200	
108,633,988	*Less* Depreciation and amounts written off . .		129,547,972	
358,785,773	Net Book Value (Note 3)		398,259,228	
16,585,954	Goodwill, Patents, Trade Marks, etc. at cost *less* amounts written off . .		16,878,537	
375,371,727				415,137,765
16,768,366	INTERESTS IN ASSOCIATED COMPANIES (Note 5) . .			19,080,327
	CURRENT ASSETS			
115,230,073	Stocks at or under cost		122,469,810	
68,744,239	Debtors, including Housing and other Loans (Note 6) . .		74,535,310	
4,799,398	Marketable Investments (Market value £7,857,472) .		7,671,024	
3,100,000	Tax Reserve Certificates .		4,400,000	
7,072,526	Cash at Bankers and in hand . .		12,310,911	
198,946,236			221,387,055	
	Less CURRENT LIABILITIES	£		
46,716,241	Creditors	50,752,899		
50,123,672	Provisions for Taxation and other Liabilities . .	49,575,072		
3,306,638	Bank Overdrafts: Secured . . .	3,734,547		
11,543,497	Bank Overdrafts: Unsecured	6,323,976		
111,690,048			110,386,494	
87,256,188				111,000,561
£479,396,281				£545,218,653

FINANCED AS FOLLOWS:

	CAPITAL AND RESERVES OF MEMBERS OF IMPERIAL CHEMICAL INDUSTRIES LIMITED		
£	**Capital**	£	
33,708,773	5% Cumulative Preference Stock . .	33,708,773	
143,045,436	Ordinary Stock . . .	144,233,090	
176,754,209			177,941,863
	Reserves employed in the business (Note 7)		
121,847,086	Capital	128,314,665	
64,617,670	Revenue	71,434,321	
186,464,756			199,748,986
363,218,965			377,690,849
21,199,962	CAPITAL AND RESERVES APPLICABLE TO MINORITY MEMBERS OF SUBSIDIARIES . .		23,196,189
	FUTURE UNITED KINGDOM INCOME TAX		
13,254,208	Reserve for estimated liability 1958/59	14,016,666	
11,178,474	Reserve for deferred liability due to initial allowances	12,953,336	
24,432,682			26,970,002
	DEBENTURES AND LOANS		
18,629,623	Debentures and Secured Loans .	25,541,068	
51,915,049	Unsecured Loans	91,820,545	
70,544,672			117,361,613
£479,396,281			£545,218,653

J. H. COTTON, *Treasurer.*

S. P. CHAMBERS
P. T. MENZIES } *Directors.*

NOTES RELATING TO THE ACCOUNTS FOR 1957

The foregoing accounts should be considered in conjunction with the following notes:

(1) Contributions to Pension Funds, Pensions and Gratuities.

The charges for Pensions and Gratuities cover payments to Contributory Pension Funds for Staff, Foremen and Workers, Pensions and Gratuities and include provisions of £265,000 (*1956 £800,000*) towards anticipated future solvency guarantee payments.

(2) Taxation.

Company 1956 £	Company 1957 £		Group 1956 £	Group 1957 £
13,562,520	14,265,315	U K. Income Tax	14,541,724	14,609,704
4,835,244	5,863,273	U K. Profits Tax	5,368,777	6,358,239
506 622	*429,670*	Overseas Taxes (net after reliefs)	3,645,896	3,746,004
17,891,142	19,698,918		23,556,397	24,713,947
391,000	1,694,000	Transfer to Reserve for Deferred Income Tax Liability due to Initial Allowances	392,525	1 774 862
18,282,142	21,392,918		23,948,922	26,488,809
132,873	219,356	*Less* Overpr in past years	184,088	160,731
£18,149,269	£21,173,562		£23,764,834	£26,328,078

The appropriate provisions for U K and Overseas Taxation have been made (a) in the Company Balance Sheet on profi earned to 31st December 1957 and (b) in the Group Balance Sheet on profits earned to the dates of the respective balance shee included therein

The transfers of £1,694 000 (Company) and £1,774,862 (Group) to Reserve for Deferred Income Tax Liability due t Initial Allowances shown above are the estimated benefits for the year from the temporary saving in U K Income Tax due t initial allowances for 1957, less the additional income tax arising because annual allowances have been reduced by reason o initial allowances in previous years

The net tax charges for the year have been computed after deducting reliefs in respect of investment allowances in the case of the Company of £1,393,203 (*1956 £2,186,135*) and in the case of the Group of £1,475,978 (*1956 £2,312,453*)

(3) Property, Plant and Equipment.

	Land and Buildings			Plant, Machinery, Transport and Rolling Stock			Sundry Equipment and Office Furniture	Total
	Cost or as revalued in 1950 £	Amounts written off £	Net Book Value £	Cost or as revalued in 1950 £	Amounts written off £	Net Book Value £	Net Book Value £	Net Book Value £
(a) Company								
At 31st December 1956	85,209,344	13,637,810	71,571 534	282,407,162	61,225,048	221,182,114	3,247,847	296,001,495
Capital Expenditure	8,710,233	—	8,710,233	40,790,155	-	40,790,155	1 056,752	50,557,140
	93,919,577	13,637,810	80,281,767	323,197,317	61,225,048	261,972,269	4,304,599	346,558,635
Sales, Demolitions, Transfers and Adjustments	*25,100*	*7,990*	*17,110*	*2,187,699*	*1,026,780*	*1,160,919*	48,345	*1,129,684*
	93,894,477	13,629,820	80,264,657	321,009 618	60,198,268	260 811,350	4,352,944	345,428,951
Depreciation	—	2,914,267	*2,914,267*	--	15,873,379	*15,873 379*	*475 896*	*19,263,542*
At 31st December 1957	93,894,477	16,544,087	77,350,390	321,009,618	76,071,647	244,937,971	3,877,048	326,165,409
(b) Group								
At 31st December 1956	128,045,603	23,912,184	104,133,419	334,601,771	84,721,804	249,879,967	4,772,387	358,785,773
Capital Expenditure	15,861,107	—	15,861,107	50,074,576	-	50,074,576	1,719,597	67,655,280
	143,906 710	23,912,184	119,994,526	384 676,347	84,721,804	299,954,543	6,491,984	426,441,053
Sales, Demolitions, Transfers and Adjustments	*1,767,87*	*495,848*	*1,272,031*	*4 750,618*	*2 408,169*	*2,342 449*	*38,607*	*3,653,087*
	142,138,831	23,416,336	118,722,495	379,925,729	82,313,635	297,612 094	6,453 377	422,787,966
Depreciation		4,172,165	*4,172,165*		19,645,836	*19,645,836*	*710,737*	*24,528,738*
At 31st December 1957	142,138,831	27,588,501	114,550,330	379,925,729	101,959,471	277,966,258	5,742,640	398,259,228

(4) Interests in Subsidiaries.

The Company's investments in and advances to and from Subsidiaries, including dividends (less tax) due for the year, are as follows:—

	1956	1957
	£	£
Shares at cost or as revalued less provisions and amounts written off	36,183,713	36,896,413
Advances to Subsidiaries	24,525,670	27,068,342
	60,709,383	63,964,755
Less. Advances from Subsidiaries	6,312,106	6,183,872
	£54,397,277	£57,780,883

(5) Interests in Associated Companies.

Company 1956	Company 1957		Group 1956	Group 1957
£	£		£	£
7,075,873	7,645,991	Shares and Debentures at cost or as revalued	15,430,261	17,741 898
376,920	376,920	*Less:* Provisions and amounts written off	688,256	687,932
6,698,953	7,269,071		14,742,005	17,053,966
526,361	526,361	Advances to Associated Companies	2,026,361	2,026,361
£7,225,314	£7,795,432		£16,768,366	£19,080,327

(6) Employees' Share Investment Scheme.

Included in Debtors in the Company and Group Balance Sheets is an amount of £83,425 (*1956 £43,500*) in respect of a loan to the Trustees of the Employees' Share Investment Scheme.

(7) Reserves.

Details of the Company's Reserves and movements in the Company and Group Reserves are as follows:—

Capital Reserves	Company: General	Company: Share Premium Account	Company: Revaluation of Physical Assets	Company: Replacement of Assets	Company: Total	Group: Total
	£	£	£	£	£	£
At 31st December 1956	31,791,988	2 414,227	37,943,332	43,000,000	115,149,547	121,847,086
Share premiums received during the year	—	1,222,309			1,222,309	1,222,309
Appropriations from profits of the year—Company	1,500,000	—		7,000,000	8,500,000	8,500,000
Profits less losses on realisation of investments	349,018	—			349,018	431,906
Amounts written off less profits on realisation of physical assets, less other capital receipts	*526,507*	—			*526,507*	*524,456*
5½% Loan Stock—Discount and issue expenses written off	*2,523,062*	—			*2,523,062*	*2,523,062*
Transfers from Revenue Reserves						319,689
Exchange differences						*990,799*
Changes in percentage holdings and adjustments on consolidation						31,992
At 31st December 1957	30,591,437	3,636,536	37,943,332	50,000,000	122,171,305	128,314,665

Revenue Reserves	Company: General	Company: Stock Replacement	Company: Total	Group: Total
	£	£	£	£
At 31st December 1956	33,060,867	11,952,580	45,013,447	64,617,670
Appropriation from profits of the year—Company	2,720,584	—	2,720,584	2,720,584
Release from Stock Replacement Reserve—Company	2,500,000	*2,500,000*		
Dividend (less income tax £846,553) from a subsidiary representing reserves accumulated in past years	1,145,336	—	1,145,336	
Undistributed income of the year—Subsidiaries				4,692,552
Transfers to Capital Reserves				*319,689*
Exchange differences				*222,712*
Changes in percentage holdings and adjustments on consolidation				*54,084*
At 31st December 1957	39,426,787	9,452,580	48,879,367	71,434,321

(8) Commitments.

Commitments for Capital Expenditure at the date or dates of the respective balance sheets amounted in the case of the Company to approximately £m.30.2 (*1956 £m.32.6*) and in the case of the Group to approximately £m 37.6 (*1956 £m 41 4*).

The Company is committed to pay to the Trustees of the Workers' Pension Fund nineteen annual instalments of (a) £189,417 on account of the initial liability assumed in 1936 in respect of the past services of workers, (b) £303,600 for the cost of improvements in benefits granted from 1st October 1952 and (c) £246,960 for the cost of improvements in benefits granted from 1st July 1957.

There is a further commitment to pay to the Trustees of the Staff and Foremen's Pension Funds the sum of £2,158,000 in five annual instalments of £431,600 to meet the cost of increases in pensions granted from 1st July 1957 against which £1,398,000 has been provided out of profits (£1,208,000 in prior years against Pension Fund liabilities and £190,000 from the profits of the year).

(9) Contingent Liabilities.

Contingent liabilities existed at 31st December 1957 in connection with (a) guarantees and uncalled capital relating to subsidiaries and associated companies and (b) guarantees relating to the Company's Pension Funds

(10) Remuneration of Directors.

The remuneration of the Directors of the Company included as a charge in the year's accounts amounted to £510,441 made up of Fees £47,989, Other Emoluments £298,430 and Pensions, commutation of Pensions and Gratuities to former Executive Directors £164,022. Directors received £4,500 by way of Fees from other Companies to whose Boards they were nominated by the Company.

(11) Balance Sheet Dates.

Without unduly delaying the preparation of the Group Accounts it is impracticable for thirty seven oversea subsidiaries to provide accounts made up to a date later than 30th September and in addition, owing to local conditions, four make up their accounts at 30th June. In the case of seventeen of the home subsidiaries, seasonal trade or oversea interests preclude the making up of accounts to 31st December. The Group Accounts accordingly include the accounts of all these subsidiaries made up either to 30th June or 30th September 1957. The net difference on inter-company accounts from this cause amounts to £1,654,565 and is included in Sundry Debtors. The difference is due principally to shipments to oversea subsidiaries during the period from 30th September 1957 to 31st December 1957 exceeding remittances received from them in the same period

(12) Currency Assets and Liabilities.

Currency assets and liabilities have been converted into sterling at the rates of exchange ruling at the dates of the respective balance sheets except in the case of the subsidiaries in Brazil, Chile and Uruguay, where the rate ruling at 31st December 1957 has been used.

THE IMPERIAL TOBACCO COMPANY (O

PROFIT AND LOSS ACCOUNT for the year ended 31st October, 1958.

		1958 £		1957	
(I)	**TRADING PROFIT** (See Note 6) ..		21,107,120		18,20
(II)	**DIVIDENDS AND INTEREST** from				
	Subsidiaries	1,070,733		999,153	
	Trade Investments	5,395,390		5,154,626	
	Other sources	8,871		7,991	
			6,474,994		6,161,
(III)	**PROFIT FOR YEAR (BEFORE CHARGING UNITED KINGDOM TAXATION)**		27,582,114		24,364
(IV)	**UNITED KINGDOM TAXATION**—				
	Estimated to be payable on profit for the year —				
	Profits Tax	2,640,000		2,985,000	
	Income Tax: including £10,213,681 (1957 £9,124,162) set aside for future Income Tax	11,670,000		10,460,000	
			14,310,000		13,445,00
(V)	**PROFIT FOR YEAR AVAILABLE FOR APPROPRIATION**		13,272,114		10,919
(VI)	**APPROPRIATIONS**—				
	General Reserve	3,500,000		3,500,000	
	Contingencies Reserve	2,000,000		—	
			5,500,000		3,500,00
			7,772,114		7,419
(VII)	**DIVIDENDS PAID AND PROPOSED**—				
	Preference Stocks:—				
	Half-year to 30th April, 1958 (paid) less Income Tax	245,010		245,010	
	Half-year to 31st October, 1958 (payable) less Income Tax	245,010		245,010	
	Ordinary Stock:—				
	Interim Dividend of 8½% less Income Tax	2,937,431		2,937,431	
	Proposed Final Dividend of 12½% less Income Tax	4,319,751		3,974,171	
			7,747,202		7,401,6
(VIII)	**BALANCE OF PROFIT FOR YEAR**		£24,912		£17,

Y (GREAT BRITAIN AND IRELAND), LIMITED

NSOLIDATED PROFIT AND LOSS ACCOUNT for the year ended 31st October, 1958.

		1958		1957	
				£	£
18,202,	(I) **TRADING PROFIT** (See Note 6)		24,293,066		21,554,565
	(II) **DIVIDENDS AND INTEREST**—from				
	Subsidiary not consolidated	87,806		89,182	
	Trade Investments .	5,395,390		5,154,626	
	Other sources	9,728		8,567	
6,161			5,492,924		5,252,375
	(III) **PROFIT FOR YEAR (BEFORE CHARGING UNITED KINGDOM TAXATION)**				
4,364,24			29,785,990		26,806,940
	(IV) **UNITED KINGDOM TAXATION**—				
	Estimated to be payable on profit for the year—				
	Profits Tax...	2,998,074		3,473,001	
	Income Tax: including £11,270,994 (1957 £10,241,402) set aside for future Income Tax .	12,461,633		11,327,028	
3,445,00			15,459,707		14,800,029
	(V) **PROFIT FOR YEAR AVAILABLE FOR APPROPRIATION**				
0,919,34			14,326,283		12,006,911
	(VI) **PROFITS APPLICABLE TO SHARES IN SUBSIDIARIES HELD OUTSIDE THE GROUP**—				
3,500,00	Preference Shares (Dividends paid and proposed, less Income Tax)	1,983		2,062	
7,419,24					
	(VII) **APPROPRIATIONS**				
	Revenue Reserves.	6,485,019		4,549,309	
	Amounts written off Goodwill (Subsidiaries)	81,005		12,598	
	(VIII) **DIVIDENDS PAID AND PROPOSED**—				
	IMPERIAL TOBACCO COMPANY:—				
	Preference Stocks (less Income Tax) .	490,020		490,020	
	Ordinary Stock (less Income Tax). .	7,257,182		6,911,602	
401,6			14,315,209		11,965,591
£17,6	(IX) **BALANCE OF PROFIT FOR YEAR**		£11,074		£41,320

THE IMPERIAL TOBACCO COMPANY (OF
AND
CONSOLIDATED BALANCE

	AUTHORISED in shares of £1 each	ISSUED and converted into Stock 1958		1957
CAPITAL OF THE IMPERIAL TOBACCO COMPANY—				
"A" 5½% Cumulative Preference	6,000,000	4,959,249		
"B" 6% Non-Cumulative Preference	6,000,000	5,260,469		
"C" 10% Non-Cumulative Preference	3,000,000	2,638,218		
Ordinary	70,000,000	60,100,880		
	85,000,000	72,958,816		72,958,816
CAPITAL RESERVES		765,113		760,713
REVENUE RESERVES AND SURPLUS—				
Reserves at 31st October, 1957	54,400,801			
Add: Transfer from Profit and Loss Account	6,485,019			
Profits, less losses, on realisation of investments	27,294			
		60,913,114		54,400,801
Profit and Loss Account—				
Balance brought forward from previous year	1,957,972			
Add: Balance for year ended 31st October, 1958	11,074			
		1,969,046		1,957,972
		136,606,089		130,078,302
AMOUNTS SET ASIDE FOR FUTURE INCOME TAX		11,270,994		10,241,402
OUTSIDE INTERESTS IN SUBSIDIARIES		38,654		39,642
LOAN CAPITAL—				
3¼% Notes, 1953-58	—		10,000,000	
3¾% Notes, 1965	15,000,000		15,000,000	
4% Unsecured Loan Stock, 1960-70	20,000,000		20,000,000	
4% Unsecured Loan Stock, 1975-80	20,000,000		20,000,000	
		55,000,000		65,000,000
OTHER BORROWED MONEY—				
Bank overdrafts	29,055,596		26,416,513	
Deposits by Associated and other companies	7,430,214		7,917,056	
		36,485,810		34,333,569
		239,401,547		239,692,915
OTHER LIABILITIES—				
Creditors, Taxation and accrued liabilities	26,355,455		28,799,323	
Dividends on Preference Stocks and Shares (less Income Tax) accrued at 31st October, 1958—				
Imperial Tobacco Company	245,010		245,010	
Subsidiaries (outside shareholders)	983		1,012	
Proposed Final Dividend on Ordinary Stock (less Income Tax)—				
Imperial Tobacco Company	4,319,751		3,974,171	
		30,921,199		33,019,516
		£270,322,746		£272,712,431

(OF REAT BRITAIN AND IRELAND), LIMITED
AND BSIDIARIES.
ANCE HEET, 31st October, 1958.

	1958 £	1958 £	1957 £	1957 £
FIXED ASSETS—				
LAND AND BUILDINGS:				
At cost and at valuation	21,627,672		20,205,850	
At book value on 1st July, 1948	203,163		203,163	
	21,830,835		20,409,013	
Less: Provisions for depreciation	7,053,888		6,647,359	
		14,776,947		13,761,654
PLANT, MACHINERY, ETC.:				
At cost and at valuation	36,487,835		33,012,757	
At book value on 1st July, 1948, less proceeds of sales	324,151		325,362	
	36,811,986		33,338,119	
Less Provisions for depreciation	18,808,308		17,163,992	
		18,003,678		16,174,127
		32,780,625		29,935,781
GOODWILL, PATENT RIGHTS AND TRADE MARKS:				
At cost, less proceeds of sales	10,083,475		10,005,530	
Less: Amounts written off	392,688		312,033	
	9,690,787		9,693,497	
Arising on the incorporation of the book value of the net assets of Subsidiaries in the Consolidated Balance Sheet	191,625		189,094	
		9,882,412		9,882,591
		42,663,037		39,818,372
SUBSIDIARIES NOT CONSOLIDATED (See Note 5)—				
Shares at cost	905,787		905,787	
Loan	361,827		361,827	
		1,267,614		1,267,614
TRADE INVESTMENTS				
Shares (quoted) at cost (Market value:—1958 £86,805,654, 1957 £60,078,187)	12,268,676		12,268,676	
Shares (not officially quoted) at cost	414,443		477,217	
Loan	789,176		789,176	
		13,472,295		13,535,069
CURRENT ASSETS—				
Stock at or below approximate cost and advances to leaf buying organisations abroad	152,494,020		157,973,588	
Debtors	60,054,778		59,434,250	
General Investments (See Note 4)	77,182		80,751	
Bank balances and cash	293,820		602,787	
		212,919,800		218,091,376

P. V. ROBERTS,
Chartered Accountant,
Chief Accountant.

SINCLAIR OF CLEEVE, *Chairman.*
R. S. W. CLARKE, *Deputy Chairman.*
W. SOMMERVILLE, *Secretary.*

		£270,322,746		£272,712,431

NOTES ON THE ACCOUNTS

1. (a) The Holding Company and certain of its Subsidiaries have obligations under guarantees in respect of their employees' Pension Schemes (not provided for in these accounts) which will be discharged by annual payments. For the Holding Company these payments are £312,460 per annum for the next 10 years, and £75,760 per annum for each of the following 7 years; for the Subsidiaries they are £53,194 per annum for next year, £29,170 per annum for a further 2 years, £26,940 per annum for the next year, £17,640 per annum for a further 5 years, and £10,570 per annum for each of the 2 following years.

(b) The Holding Company has commitments under an agreement with an Associated Company.

(c) There are contingent liabilities amounting to £457,500 on partly-paid investments of the Holding Company.

2. The approximate amounts of contracts for capital expenditure not provided for in the accounts are:—

Holding Company	£1,100,000	(1957: £1,950,000)
Subsidiaries	£2,570,000	(1957: £4,150,000)

3. The book values of assets and liabilities in foreign currencies have been converted into sterling on the following bases:—
   (a) Fixed assets in U.S.A. and Canada purchased before 31st October, 1939: at $4.86 to £1.
   (b) Other fixed assets: at rates ruling when purchased.
   (c) Advances to leaf buying organisations abroad: at cost of remittances.
   (d) Other current assets and liabilities: at the rates of exchange ruling on 31st October, 1958.

4. The general investments consist of:—

	1958	1957
	£	£
Quoted Investments	4,682	13,808
Unquoted Investments	72,500	66,943
	77,182	80,751
Market value of Quoted Investments ..	10,781	21,079

5. (a) The Board of Trade has given approval for the accounts of a group of Subsidiaries trading in Canada not to be dealt with in the group accounts on the ground that the business of the Holding Company and that of these Subsidiaries are so different that they cannot reasonably be treated as a single undertaking.

NOTES ON THE ACCOUNTS

(a) *continued*

The financial years of these Subsidiaries end on 30th April and the Directors consider that it is inadvisable to alter this date.

The net aggregate amount, so far as it concerns the Holding Company, of these Subsidiaries' profits, less losses, not dealt with in these accounts was (after charging Canadian Corporation tax) $ Can. 550,058 (including $ Can. 54,604 surplus on realisation of capital assets and investments) for the year to 30th April, 1958 and $ Can. 1,179,242 (including $ Can. 95,646 surplus on realisation of capital assets and investments) for the period from the date of acquisition (1st December, 1953) to 30th April, 1957.

There has been credited in the Consolidated Profit and Loss Account £69,449 in respect of a dividend paid out of profits earned up to 30th April, 1957 and £18,357 in respect of loan interest.

(b) The Directors are of the opinion that the financial year of a Subsidiary engaged in buying leaf tobacco abroad should terminate soon after the end of the buying season. For this reason the accounts of one Subsidiary included in the group accounts are for the year ended 30th April, 1958.

6. The Trading Profit is arrived at after deducting:—

	Holding Company		Group	
	1958	1957	1958	1957
	£	£	£	£
Depreciation	1,725,671	1,668,961	2,625,576	2,463,473
Audit fees and expenses	19,315	19,555	25,599	25,506
Interest paid and accrued on Notes	860,416	887,500	860,416	887,500
Interest paid and accrued on Unsecured Loan Stocks ..	1,600,000	1,600,000	1,600,000	1,600,000
Bank and other interest	2,125,890	2,502,214	2,028,170	2,364,072

7. The total emoluments of Directors of the Holding Company (including contributions to Pension schemes) were:—

	1958	1957
	£	£
Fees	10,000	10,000
Remuneration as Managers	307,328	299,448
Retirement gratuities and pensions to past and present Directors arising from service as Managers.. ..	20,629	15,623

MIDLAND BA
BALANCE SHEE

31 Dec., 1957 £			
	Share Capital Authorised:		
45,200,000	45,200,000 Shares of £1 each		45,200,000
	Share Capital Issued:		
16,155,709	16,155,709 Shares of £1 each, fully paid		16,155,709
16,155,709	Reserve Fund [including Share Premium Account £1,874,136 (*1957: £1,874,136*)]		16,155,709
905,968	Balance of Profit and Loss Account		917,891
33,217,386			33,229,309
836,058	Dividend payable 17th February, 1959, *less* Income Tax		836,058
1,478,774,467	Current, Deposit and other Accounts, including Contingency Reserves and provision for taxation.	1,554,951,078	
27,442,921	Balances in account with Subsidiary Banks and Companies ...	24,296,685	
1,506,217,388			1,579,247,763
24,764,308	Acceptances and Confirmed Credits on account of Customers		22,166,694
37,640,682	Engagements on account of Customers (*see Note 3*)		38,504,730
£1,602,675,822			£1,673,984,554

MONCKTON OF BRENCHLEY *Chairman* WILLIAM DONALD *Deputy Chairman* STANLEY ADAMS *Director*

PROFIT AND LOSS ACCOUNT Ye

1957 £		£	£
200,000	Appropriations to Bank Premises and other properties Account ...	250,000	
1,000,000	Appropriations to Reserve for Future Contingencies	1,000,000	
1,200,000			1,250,000
784,459	Interim Dividend, paid 14th July, 1958, at the rate of 9 per cent actual *less* Income Tax	836,058	
836,058	Proposed Final Dividend, payable 17th February, 1959, at the rate of 9 per cent actual *less* Income Tax	836,058	
1,620,517			1,672,116
905,968	Balance carried forward to next Account		917,891
£3,726,485			£3,840,007

LAN[ANK LIMITED

HEE -31st DECEMBER, 1958

31 Dec., 1957 £				
127,278,032	Coin, Bank Notes and Balances with the Bank of England			126,009,727
80,509,886	Balances with, and cheques in course of collection on other banks in the British Isles			82,885,429
110,183,242	Money at Call and Short Notice			139,129,724
	Bills Discounted:			
305,793,828	British Treasury Bills		260,618,449	
45,201,426	Other Bills		32,062,454	
350,995,254				292,680,903
	Quoted Investments:			
451,479,674	Securities of, or guaranteed by, the British Government all of which mature within eleven years, the average period to maturity being within five years (*see Note 1*)		475,368,196	
226,162	Other Investments at or under cost and below Market Value		51,509	
451,705,836				475,419,705
1,675,664	Sundry Unquoted Investments at cost, *less* provisions (*see Note 2*)			1,668,664
	Advances:			
397,454,010	Customers and other Accounts, *less* provision for Doubtful Debts		472,319,882	
—	Subsidiary Companies		84,763	
691,042	Midland Bank Executor and Trustee Company Limited: Loans on behalf of clients		747,837	
398,145,052				473,152,482
62,404,990	Liabilities of Customers for Acceptances, Confirmed Credits and Engagements (*see Note 3*)			60,671,424
	Shares in Subsidiary Banks and Companies:			
	Belfast Banking Company Limited:	£		
800,000	200,000 Shares of £12 10s. each, £4 paid	800,000		
1,296,479	Reserve and Undivided Profits	1,252,305		
2,096,479			2,052,305	
	Clydesdale & North of Scotland Bank Limited:			
1,000,000	100,000 Shares of £50 each, £10 paid	1,000,000		
1,141,000	65,200 Shares of £50 each, £17 10s. paid	1,141,000		
300,000	30,000 Shares of £10 each, fully paid	300,000		
3,902,054	Reserve and Undivided Profits	3,914,881		
6,343,054			6,355,881	
	Midland Bank Executor and Trustee Company Limited:			
250,000	200,000 Shares of £5 each, £1 5s. paid	250,000		
317,823	Share Premiums, Reserve and Undivided Profits	324,101		
567,823			574,101	
	Forward Trust Limited, at cost, *less* amounts written off (*see pages 10, 11 and 12*): 55,975 6% Cumulative Preference Shares of £1 each, fully paid; 448,090 Ordinary Shares of 10s. each, fully paid		1,623,332	
Nil	Sundry Nominee Companies at cost, *less* amounts written off		Nil	
				10,605,619
10,770,510	Bank Premises and other properties at cost, *less* amounts written off and provisions			11,760,877
£1,602,675,822				£1,673,984,554

O. E. WOOD *Chief General Manager*

UNT Year ended 31st DECEMBER, 1958

1957 £		
2,846,687	Net Profit for the year, including the sum of £321,069 (*1957: £321,069*) Dividends receivable from Subsidiary Banks and Companies and after providing for taxation, depreciation of Bank Premises and other properties and appropriations to Contingency Accounts out of which Accounts full provision has been made for all Bad and Doubtful Debts and any other diminution in the value of assets	2,934,039
879,798	Balance from last Account	905,968
£3,726,485		£3,840,007

MIDLAND BANK LIMITED AND ITS WHOL)W

CONSOLIDATED BALANCE SHE[illegible]31

BELFAST BANKING COMPANY LIMITED . BELFAST BANK EXECUTOR AND TRUS[illegible] OMP
MIDLAND BANK EXECUTOR AND TRUSTEE COMPANY LIMITED MIDLA[illegible] ANK

31 Dec., 1957		
£		
	Share Capital Authorised	
45,200,000	45,200,000 Shares of £1 each	45,200,000
	Share Capital Issued.	
16,155,709	16,155,709 Shares of £1 each, fully paid	16,155,709
16,155,709	Reserve Fund (including Share Premium Account £1,874,136 (*1957 £1,874,136*)] ...	16,155,709
905,968	Balance of Profit and Loss Account	917,891
33,217,386		33,229,309
26,827,601	Notes in Circulation	26,499,162
836,058	Dividend payable 17th February, 1959, *less* Income Tax .. .	836,058
1,697,175,747	Current, Deposit and other Accounts, including Contingency Reserves and provision for taxation	776,445,926
25,921,189	Acceptances and Confirmed Credits on account of Customers ..	22,769,469
45,162,186	Engagements on account of Customers (*see Note 3*) . .	46,305,863
£1,829,140,167		£1,906,085,787

MONCKTON OF BRENCHLEY *Chairman* WILLIAM DONALD *Deputy Chairman* STANLEY ADAMS *Director*

CONSOLIDATED PROFIT AND LOSS ACCOU[illegible] Ye

1957			
200,000	Appropriations to Bank Premises and other properties Account	250,000	
1,150,000	Appropriations to Reserves for Future Contingencies	1,225,000	
		1,475,000	
Add 48,754	*Less* Decrease in Contingency Reserve in the Accounts of Midland Bank Limited, in respect of net adjustments to the value of investments in Banking and Trustee Subsidiaries as a result of appropriations having reduced the aggregate balances on their Profit and Loss Accounts . .	25,069	
1,398,754			1,449,931
	Dividends paid or payable to the Members of Midland Bank Limited, *less* Income Tax:		
	Interim Dividend paid 14th July, 1958	836,058	
	Proposed Final Dividend payable 17th February, 1959	836,058	
1,620,517			1,672,116
905,968	Balance carried forward		917,891
£3,925,239			£4,039,938

HOL[illegible] WNED BANKING AND TRUSTEE SUBSIDIARIES
SHE[illegible] 31st DECEMBER, 1958

ND TRU[illegible] OMPANY LIMITED CLYDESDALE & NORTH OF SCOTLAND BANK LIMITED
MIDL[illegible] ANK EXECUTOR AND TRUSTEE COMPANY (CHANNEL ISLANDS) LIMITED

31 Dec., 1957			
£			£
158,454,987	Coin, Bank Notes and Balances with the Bank of England		156,238,655
88,044,931	Balances with, and cheques in course of collection on other banks in the British Isles		89,712,881
127,283,242	Money at Call and Short Notice		157,379,724
	Bills Discounted.		
309,793,828	British Treasury Bills	264,618,449	
45,512,916	Other Bills	32,258,293	
355,306,744			296,876,742
	Quoted Investments		
548,794,796	Securities of, or guaranteed by, the British Government (*see Note 1*)	569,863,916	
1,442,732	Other Investments, at or under cost and below Market Value	1,268,741	
550,237,528			571,132,657
6,397,055	Sundry Unquoted Investments at cost, *less* provisions (*see Note 2*)		6,426,230
	Advances		
459,821,081	Customers and other Accounts, *less* provision for Doubtful Debts	542,821,640	
—	Subsidiary Companies	94,006	
			542,915,646
71,083,375	Liabilities of Customers for Acceptances, Confirmed Credits and Engagements (*see Note 3*)		69,075,332
—	Shares in Subsidiary Company at cost, *less* amounts written off not consolidated (*see pages 10, 11 and 12*)		2,712,641
12,511,224	Bank Premises and other properties at cost, *less* amounts written off and provisions		13,595,279
£1,829,140,167			£1,906,085,787

C F WOOD *Chief General Manager*

O[illegible] Year ended 31st DECEMBER, 1958

1957		
£		
3,039,719	Net Profit of the Group for the year after meeting all charges, providing for taxation and after appropriations to Contingency Accounts, out of which Accounts full provisions have been made for Bad and Doubtful Debts and any other diminution in the value of assets, except to the extent of an unrealised diminution in value of British Government Securities amounting at 31st December, 1958, to £615,508 (*1957 £31,452,788*) (*see Note 1*)	3,133,970
885,520	Balance brought forward from previous year	905,968
£3,925,239		£4,039,938

FORWARD TRUST LIMITED

and its Subsidiary, FORWARD DISCOUNT COMPANY LIMITED

As a result of an offer dated 28th August, 1958, Midland Bank Limited and Clydesdale & North of Scotland Bank Limited acquired 95,975 6 per cent Cumulative Preference Shares of £1 each and 748,090 Ordinary Shares of 10s. each fully paid of FORWARD TRUST LIMITED made up as follows:—

	6 per cent Cumulative Preference Shares of £1 each	*Ordinary Shares of 10s. each*
	£	£
Acquired by Midland Bank Limited	55,975	224,045
Acquired by Clydesdale & North of Scotland Bank Limited	40,000	150,000
Total	95,975	374,045
Held by other Shareholders	4,025	955
TOTAL ISSUED SHARE CAPITAL	100,000	375,000

The audited accounts of Forward Trust Limited are made up to 30th April and in view of the nature of its business it is not considered practicable to prepare accounts co-terminous with those of the holding Company Accordingly, a consolidated statement showing the financial position of Forward Trust Limited and its Subsidiary, Forward Discount Company Limited, as at 30th April, 1958, and a consolidated statement of Profit and Loss of those Companies for the year ended at that date are shown on pages 11 and 12 as part of the Group Accounts.

The interests of the members of Midland Bank Limited in the share capital and reserves and profits of Forward Trust Limited and its Subsidiary as disclosed in the following Statements of Account are:

	Midland Bank Limited	*Clydesdale & North of Scotland Bank Limited*	*Total*
	£	£	£
Issued Share Capital:			
6 per cent Cumulative Preference Shares of £1 each	55,975	40,000	95,975
Ordinary Shares of 10s each	224,045	150,000	374,045
Total Share Capital	280,020	190,000	470,020
Share Premium Account	59,745	40,000	99,745
Pre-acquisition Reserves and Profits	215,371	144,193	359,564
TOTAL	555,136	374,193	929,329

FORWARD TRUST LIMITED

and its Subsidiary, FORWARD DISCOUNT COMPANY LIMITED

CONSOLIDATED STATEMENT SHOWING FINANCIAL POSITION AS AT 30th APRIL, 1958

1957 £		£	£
	Fixed Assets:		
15,475	Lease, Furniture, Fixtures and Motor Cars, at cost ..	19,675	
7,393	*Less* Accumulated Depreciation and Amortisation ...	10,543	
£8,082			9,132
	Current Assets		
4,955,171	Hirers' Balances and Advances, *less* Provision for Doubtful Debts, £132,000 (*1957, £112,000*)	6,939,438	
47,950	Vehicles and Plant and Machinery let on Hire, *less* amounts written off	169,739	
5,279	Balances at Bankers Midland Bank Group	4,628	
144	Cash in Hand..	514	
1,830	Prepayments and Interest Accrued..	10,695	
£5,010,374			7,125,014
5,018,456			7,134,146
	Less Current Liabilities:		
1,488,218	Bankers and Acceptances (Midland Bank Group £1,345,442—*1957*, £1,198,855)	1,986,547	
1,650,925	Deposits	2,932,550	
25,023	Sundry Creditors .	28,457	
179,274	Taxation	215,535	
37,734	Proposed Final Ordinary Dividend, *less* Income Tax	37,734	
£3,381,174			5,200,823
1,637,282			1,933,323
575,000	*Less* Unearned Finance Charges	795,000	
184,472	Income Tax 1959–60 .	202,840	
759,472			997,840
£877,810	NET ASSETS		£935,483
	Representing.		
100,000	6 per cent Cumulative Preference Shares of £1 each		100,000
375,000	Ordinary Shares of 10*s*. each		375,000
100,000	Capital Reserve (Share Premium Account) ..		100,000
	Revenue Reserves:		
220,000	General		270,000
82,810	Profit and Loss Account		90,483
£877,810			£935,483

FORWARD TRUST LIMITED

and its Subsidiary, FORWARD DISCOUNT COMPANY LIMITED

CONSOLIDATED STATEMENT OF PROFIT AND LOSS

for the year ended 30th APRIL, 1958

1957					
£	£				
429,868		Profit on Trading before charging expenditure shown below			470,127
		Note Unearned Finance Charges have been increased by £220,000 (1957, reduced by £500) and Provision for Doubtful Debts increased by £20,000 (1957, £10,000)			
		Deduct			
	108,224	Deposit Interest ...		181,121	
		Directors' Emoluments			
	750	Fees . . .	750		
	11,429	Other Emoluments	13,201		
				13,951	
	726	Pension Fund Contribution for Staff other than Executive Directors		726	
	525	Auditors' Remuneration		525	
	3,447	Depreciation and Amortisation of Fixed Assets .		4,645	
		Taxation on Profits for the year			
	34,892	Profits Tax	34,879		
	138,477	Income Tax . . .	124,642		
				159,521	
298,470					360,489
131,398		Net Profit for the year			109,638
		Deduct Dividends, *less* Income Tax, attributable to outside shareholders			
	3,450	On £100,000 6 per cent Cumulative Preference Shares .		3,450	
	48,515	On £375,000 Ordinary Share Capital 22½ per cent		48,515	
	51,965			51,965	
	60,000	Transfer to General Reserve		50,000	
111,965					101,965
19,433		Balance of Profit for the year			7,673
63,377		*Add* Balance brought forward from last year			82,810
£82,810		BALANCE OF PROFIT AND LOSS ACCOUNT			£90,483

NOTES ON ACCOUNTS

1. The Investments of Midland Bank Limited and of its banking and trustee subsidiaries in British Government Securities, all of which are redeemable at fixed dates, are stated at a book value which is at or under cost and below redemption value.

   The book value of the above Investments of Midland Bank Limited, all of which mature within eleven years, the average period to maturity being within five years, amounted at the 31st December, 1958, to £475,368,196 (*1957. £451,479,674*) and the valuation of these Investments at middle market prices on the same date, less net accrued interest, was in excess of that figure (*1957. Market Value £428,581,535*)

   At the 31st December, 1958, the book value of the Investments in British Government Securities of Midland Bank Limited and of its banking and trustee subsidiaries, the large majority of which mature within ten years, was £569,863,916 (*1957. £548,794,796*) and the valuation of these Investments at middle market prices on the same date, less net accrued interest, was £569,248,408 (*1957: £517,342,008*).

   No special provisions for the difference are considered necessary, and during the year ended 31st December, 1958, no transfers have been made from Contingency or other Reserves to write down these Investments, neither have any provisions been made for this out of the current year's profits

2. In respect of certain of the unquoted investments of Midland Bank Limited there are contingent liabilities for uncalled capital amounting to £1,380,500 (*1957: £1,380,500*). The corresponding figure relative to the unquoted investments shown in the Consolidated Balance Sheet is £1,583,000 (*1957· £1,583,000*).

3. In addition to the engagements as shown in the Balance Sheet and Consolidated Balance Sheet, Midland Bank Limited has contracts running with customers for the sale and purchase of Foreign Currencies to the value of £48,614,520 (*1957: £47,065,823*). These contracts are covered by compensating contracts for a corresponding amount.

4. Midland Bank Limited and its banking and trustee subsidiaries have made full provision for the liabilities to taxation on all profits to date irrespective of when assessable.

5. The aggregate amount of the emoluments of the Directors of Midland Bank Limited for the year ended 31st December, 1958, is £81,638 (*1957: £80,196*) of which £70,676 (*1957: £68,538*) was paid by Midland Bank Limited. In addition, a payment of £3,163 (*1957: Nil*) was made to the Chairman in respect of arrears of remuneration for the year ended 31st December, 1957. Pensions of £6,101 (*1957: £4,601*) were paid by Midland Bank Limited to Directors past and present in respect of past executive or special services whilst Directors.

6. Foreign currency balances have been expressed in sterling at the rates ruling at 31st December, 1958.

7. Contracts for outstanding Capital Expenditure amount approximately to:—

(*a*) Midland Bank Limited	£1,780,000	(*1957: £1,651,000*)
(*b*) Banking and trustee subsidiaries	£ 229,000	(*1957: £ 124,000*)
	£2,009,000	(*1957: £1,775,000*)

NATIONAL BUILDING SOCIETY

Annual Account and Statement

For the year ended 31st December, 1958

1. SHARES ACCOUNT

Number of Share Investors 597,095
(Including borrowers with share accounts)

	£		
Withdrawals, including Interest	38,128,727	Subscriptions	53,283,951
Due to Shareholders at end of year	273,970,881	Interest	8,929,594
		Due to Shareholders at beginning of year	249,886,060
	£312,099,608		£312,099,608

2. DEPOSITS AND LOANS ACCOUNT

Number of Creditors for Deposits 16,184

	£		
Withdrawals, including Interest	3,315,631	Receipts from Depositors	3,955,333
Due to Creditors for Deposits at end of year	14,743,760	Interest on Deposits	376,627
		Due to Creditors for Deposits at beginning of year	13,727,431
	£18,059,391		£18,059,391

ONAL BUILDING SO

3. MORTGAGES ACCOUNT

Number of Borrowers 198,712

Advanced on Mortgage:—		Repayments of Advances, Interest and Insurance Premiums . .	37,856,447
On 23,399 Mortgages where the advance agreed to will not exceed £3,000	36,440,211	Losses on Realisation charged to Account No. 5.	12,169
On 1,023 Mortgages where the advance agreed to will exceed £3,000	4,573,565	Due on Mortgages at end of year .	254,614,812
	41,013,776		
Interest	14,808,356		
Insurance Premiums	455,934		
Due on Mortgages at beginning of year	236,205,362		
	£292,483,428		£292,483,428

4. INVESTMENTS ACCOUNT

Investments made:—		Investments realised:	
British Government Securities ..	12,832,721	British Government Securities	4,516,062
Treasury Bills	6,750,370	Treasury Bills .. .	4,050,000
Loans to Local Authorities ...	1,600,000	Loans to Local Authorities ...	5,809,751
	21,183,091		14,375,813
Profit on Realisation of Investments	201,620	Interest and Dividends received ...	1,202,625
Interest and Dividends earned ...	1,224,145	Balance at end of year	40,973,919
Balance at beginning of year ...	33,943,501		
	£56,552,357		£56,552,357

SOCIETY

5. REVENUE AND APPROPRIATION ACCOUNT

	£		£
Management Expenses –		Interest on Mortgages	14,808,356
Directors' Fees	20,000	Interest and Dividends from Investments	1,224,145
Remuneration of Staff and Auditors ..	829,300	Bank Interest	38,717
Rents, Rates, Insurance, Heat, Light, Cleaning, Repairs, etc (Offices) ..	192,710	Rents from letting of Office Premises	69,097
Printing, Stationery and Postages	113,031	Survey Fees and Expenses	167,187
Advertising . .	148,795	Mortgage Losses Recovered	380
Commission and Agency Fees	158,550	Transfer and Registration Fees	712
Bank, Legal and Professional Charges .	13,111	Commission (Fire, Life, etc Insurance)	194,383
Telephone, Travelling and Sundry Expenses	67,179		
Total Management Expenses	1,542,706		
Survey Fees and Expenses	165,191		
Interest on Deposits ...	376,627		
Losses on Mortgage .	12,169		
Depreciation of Office Premises and Equipment . .	73,882		
Income Tax .	4,360,381		
Profits Tax ..	200,577		
Supplementary Pension Scheme	100,000		
Interest to Shareholders for period ended 31st December, 1958	8,929,594		
Balance carried down	741,847		
	£16,502,977		£16,502,977
Appropriation to General Reserve	900,000	Balance brought forward from last year . .	412,875
Balance carried forward	456,342	Balance brought down	741,847
		Profit on Realisation of Investments	201,620
	£1,356,342		£1,356,342

6. GENERAL RESERVE ACCOUNT

Balance at end of year	9,300,000	Balance at beginning of year	8,400,000
		Appropriation from Account No. 5	900,000
	£9,300,000		£9,300,000

7. MORTGAGE LOSSES RESERVE ACCOUNT

	£		£
Balance at end of year	20,000	Balance at beginning of year	20,000
	£20,000		£20,000

7. (a). INVESTMENT RESERVE ACCOUNT

	£		£
Balance at end of year	1,750,000	Balance at beginning of year	1,750,000
	£1,750,000		£1,750,000

ABBEY NA SOCIETY

BALANCE SHEET A ls

I. DUE TO HOLDERS OF SHARES			£273,970,881
Holdings exceeding £5,000:—Nil			
II. DUE TO CREDITORS FOR DEPOSITS			14,743,760
Deposits repayable at:—			
One month's notice		£10,191,465	
Three months' notice		642,286	
Six months' notice		2,228,847	
Twelve months' notice		1,288,667	
Special deposits repayable in accordance with agreements		392,495	
		£14,743,760	
Holdings exceeding £5,000:—Number 205 — Total £3,457,665			
III. OTHER LIABILITIES			
Income Tax up to 5th April, 1959		£3,848,121	
Profits Tax for period ended 31st December, 1958		200,577	
Sundry Creditors		223,420	
			4,272,118
IV. RESERVES			
General Reserve		£9,300,000	
Investment Reserve		1,750,000	
Mortgage Losses Reserve		20,000	
Balance carried forward		456,342	
			11,526,342
No account has been taken of post-war credits for income tax amounting to £277,341			
			£304,513,101

1st DECEMBER, 1958

					1957
	I. MORTGAGE SECURITIES ...			£254,614,812	£236,205,362
	Balance due or outstanding on Mortgages, not including prospective interest:—				
	Mortgages from Members where the repayments are not upwards of 12 months in arrear and the Property has not been upwards of 12 months in possession of the Society:—				
39,772	Mortgages where the debt does not exceed £500		£9,705,479		
39,951	Mortgages where the debt exceeds £500 and does not exceed £1,000		29,880,460		
113,417	Mortgages where the debt exceeds £1,000 and does not exceed £3,000		191,244,988		
5,947	Mortgages where the debt exceeds £3,000 and does not exceed £5,000		20,822,002		
296	Mortgages where the debt exceeds £5,000 as shown by Part I of the Schedule		2,935,521		
	Mortgages from non-members:—				
11	Mortgages where the debt does not exceed £500	£3,238			
2	Mortgages where the debt exceeds £5,000 as shown by Part I of the Schedule	17,634			
	Balance as shown in Parts II and III of Schedule:—				
—	Mortgages on Property of which the Society has been upwards of 12 months in possession, as shown by Part II of the Schedule				
6	Mortgages where the repayments are upwards of 12 months in arrear and the Property has not been upwards of 12 months in possession of the Society, as shown by Part III of the Schedule	£5,490			
	Balance outstanding in respect of Properties for which Receivers or Managers have been appointed for upwards of 12 months – £6,828				
199,402	Mortgages—amount outstanding thereon ...		£254,614,812		
	II. INVESTMENTS				
	British Government Securities ... *Market Value at 31st December, 1958, £25,509,914*		£26,334,436		17,821,690
	Treasury Bills		2,730,313		
	Loans to Local Authorities		11,582,000		15,791,751
	Interest accrued ...		327,170		330,060
			£40,973,919		
	III. CASH AT BANK AND IN HAND		6,693,132	47,667,051	6,228,375
	IV. OFFICE PREMISES AND EQUIPMENT, at cost, less Depreciation ...			2,231,238	1,827,000
				£304,513,101	£278,204,238

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